
Audit of the Office of Hawaiian Affairs

A Report to the
Governor
and the
Legislature of
the State of
Hawai`i

Report No. 05-03
April 2005



THE AUDITOR
STATE OF HAWAI`I

The Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaii State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. *Financial audits* attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.
2. *Management audits*, which are also referred to as *performance audits*, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called *program audits*, when they focus on whether programs are attaining the objectives and results expected of them, and *operations audits*, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.
3. *Sunset evaluations* evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.
4. *Sunrise analyses* are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.
5. *Health insurance analyses* examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.
6. *Analyses of proposed special funds* and existing *trust and revolving funds* determine if proposals to establish these funds are existing funds meet legislative criteria.
7. *Procurement compliance audits* and other *procurement-related monitoring* assist the Legislature in overseeing government procurement practices.
8. *Fiscal accountability reports* analyze expenditures by the state Department of Education in various areas.
9. *Special studies* respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawaii's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.



THE AUDITOR

STATE OF HAWAII

Kekuanao'a Building
465 S. King Street, Room 500
Honolulu, Hawaii 96813

OVERVIEW

Audit of the Office of Hawaiian Affairs

Report No. 05-03, April 2005

Summary

With over \$300 million in assets, the Office of Hawaiian Affairs (OHA) is constitutionally the main vehicle for the State to meet its trust responsibilities to native Hawaiians and Hawaiians. Section 10-3, Hawaii Revised Statutes (HRS), reflects this constitutional mandate, and at least once every four years the Auditor is required to conduct an audit of OHA, pursuant to Section 10.14.55, HRS. OHA has shown little improvement in its ability to serve Hawaiians since our last audit in 2001. We found that the Board of Trustees still has not provided the State with a comprehensive master plan for bettering the conditions of native Hawaiians and Hawaiians. Although OHA has developed a strategic plan, the need for a comprehensive master plan still exists to serve as a foundation for OHA's programs, as well as the programs of other agencies that provide services to Hawaiians.

We also found that OHA is still grappling with the effects of poorly planned reorganizations. During FY2001-02 and FY2002-03, OHA hired numerous employees to fill a variety of positions, including key managerial positions. Yet, in the midst of organizational change, OHA lacks basic policies and procedures to guide the actions of its staff, and its organizational charts and functional statements are inconsistent. This situation is compounded by confusion among program directors on how OHA's priorities translate into the agency's budget. In addition, we found that OHA's casual administration of its finances does not demonstrate respect for its fiduciary duty to all Hawaiians. Certain protocol and trustee expenditures appear questionable. In addition, tighter oversight of the Native Hawaiian Revolving Loan Fund is needed to prevent deterioration of loan recipients' financial condition. The fund continues to experience high delinquencies and defaults among its loan recipients, jeopardizing the availability of resources to future Hawaiian entrepreneurs.

The certified public accounting firm of KPMG LLP (KPMG) reviewed OHA's investment portfolio and found that the agency has taken a number of important and well-reasoned steps in investing its assets. Directly supervising its money managers in the past, OHA now retains two investment advisors, each of which oversees selected money managers for OHA's classes of long-term investments; the agency also revised its investment policy statement and conducted a new asset allocation study. However, KPMG found continuing deficiencies that do not ensure compliance with OHA's fiduciary obligations. Generally, OHA's investment policy statement and investment oversight procedures lack key components, and OHA's lack of advisor oversight prevents the Board of Trustees from receiving sufficient information to evaluate the investment advisors' performance.

KPMG found duties and responsibilities related to trust fund investments are not clearly laid out in OHA's investment policy statement. In addition, critical



benchmarks for the trust fund have not been established for its investment advisors, as well as for the actions and investment decisions of OHA and its board. In addition, KPMG concluded that the lack of historical data and performance standards results in a material weakness. KPMG also found that OHA has not addressed the use of passive investments, as well as ceded land payments, in its investment policy statement. If OHA's passive assets were in line with its peer median and certain conditions were in place, fees would be reduced, saving the agency more than \$300,000 annually. KPMG also found that OHA has not created an independent function to oversee investment advisors or a standard set of contracts for the retention of investment advisors, resulting in substantially different performance measures for each of its two investment advisors.

Recommendations and Response

We recommended the Board of Trustees resurrect efforts to create a comprehensive master plan and that OHA develop appropriate management tools such as policies and procedures on action planning and budgeting. We recommended that OHA revise its Administrative Financial Manual of Guides to clarify the purposes and uses of petty cash, protocol allocations, and trustee allowances and that it provide tighter oversight of loans made from the Native Hawaiian Revolving Loan Fund. KPMG also offered several technical recommendations on OHA's investment policy statement and investment processes.

In its written response, which included a draft *2005 Master Plan*, the Board of Trustees did not disagree with our recommendations or the recommendations of KPMG. The trustees acknowledged that portions of the report will aid in improving OHA's services, but "question[ed] the substance and wording of much of [the] report." In particular, the board questioned our findings on the lack of a comprehensive master plan, unsubstantiated and questionable expenditures, and rates of delinquency and default on loans under the Native Hawaiian Revolving Loan Fund.

However, nothing offered by OHA amounts to the comprehensive master plan at issue or to appropriate substantiation of questionable expenditures. With respect to our findings on the revolving loan fund, our intent is to present a complete reading of the fund's health—not only for current borrowers, but for future Hawaiian entrepreneurs as well. OHA asserted that our calculation of a delinquency rate incorrectly included non-performing loan amounts intended for charge-off by the agency. But these non-performing loan amounts were still on OHA's books at the time of our audit, and a reading of the revolving fund's overall status without these amounts would be misleading. We confirmed with the Administration for Native Americans that our calculation was an acceptable approach. Even forms filed with the U.S. Securities and Exchange Commission report combined rates.

Our final report contains a few minor editorial changes for purposes of accuracy and style.

Marion M. Higa
State Auditor
State of Hawai'i

Office of the Auditor
465 South King Street, Room 500
Honolulu, Hawai'i 96813
(808) 587-0800
FAX (808) 587-0830

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Governor
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Conducted by

The Auditor
State of Hawai`i
and
KPMG LLP

Submitted by

THE AUDITOR
STATE OF HAWAI`I

Report No. 05-03
April 2005

Foreword

We conducted this audit of the Office of Hawaiian Affairs (OHA) pursuant to Section 10-14.55, Hawai`i Revised Statutes, which requires the Auditor to conduct an audit of OHA at least once every four years. We also engaged the certified public accounting firm of KPMG LLP as our consultant to review OHA's investment program.

We wish to express our appreciation for the cooperation and assistance extended to us by the Board of Trustees, officials, and staff of the Office of Hawaiian Affairs and others whom we contacted during the course of the audit.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

Background

Section 10-14.55, Hawai'i Revised Statutes (HRS), requires the Auditor to conduct an audit of the Office of Hawaiian Affairs (OHA) at least once every four years. Our office has conducted a total of four audits of the agency: in 1990, 1993, 1997, and 2001. Collectively, these audits identified a range of planning and managerial deficiencies on which we offered recommendations.

The State Constitution established OHA as the principal vehicle for the State to meet its trust responsibilities to native Hawaiians and Hawaiians. Section 10-3, HRS, reflects this constitutional mandate, broadly identifying OHA's purposes as including the betterment of the conditions of native Hawaiians and Hawaiians. *Native Hawaiian* includes any descendant of at least one-half part of the races inhabiting the Hawaiian Islands previous to 1778, as defined by the Hawaiian Homes Commission Act of 1920, as amended. *Hawaiian* is defined as any descendent of the aboriginal peoples inhabiting the Hawaiian islands in 1778.

Section 10-3, HRS, also designates OHA as the principal public agency in Hawai'i responsible for the performance, development, and coordination of programs and activities relating to native Hawaiians and Hawaiians, excluding the administration of the Hawaiian Homes Commission Act. OHA is also required to assess the policies and practices of other agencies that impact native Hawaiians and Hawaiians; conduct advocacy efforts for native Hawaiians and Hawaiians; apply for, receive, and disburse grants and donations from all sources for native Hawaiian and Hawaiian programs and services; and serve as a receptacle for reparations.

History of the Office of Hawaiian Affairs

In 1959, Hawai'i attained statehood through the Admission Act. This act returned to the new state 1.2 million acres of lands formerly ceded to the federal government, provided that the State hold these lands in public trust. The act also required the State to adopt the Hawaiian Homes Commission Act as a provision of the State's Constitution, and further required that 1.2 million acres of ceded lands be held in public trust for two beneficiary classes: native Hawaiians and the general public.

Section 5(f) of the Admission Act limits use of these lands, and any proceeds from their sale or disposition, to the following five purposes: 1) the support of public schools and other public education institutions;

2) the betterment of the conditions of native Hawaiians; 3) the development of farm and home ownership on as widespread a basis as possible; 4) the making of public improvements; and 5) the provision of lands for public use. Failure to limit the use of these lands and proceeds from their disposition for these purposes constitutes a breach of trust, for which the United States may bring suit against the State under the Admission Act.

Public land trust revenues and other funding sources

OHA accounts for its revenues in the Native Hawaiian Trust Fund. A major source of revenue for the agency comes from dividend and interest income. The agency also receives general fund appropriations, federal grant funds, and payments from the public land trust. This trust, under the Department of Land and Natural Resources, comprises revenues from the sale of ceded public lands and from lease rents, licenses, and permits involving ceded lands (less 30 percent of sugar cane lease land revenues required to be transferred to the Department of Hawaiian Home Lands). By law, 20 percent of the funds from the public land trust shall be expended by OHA for the betterment of conditions of native Hawaiians. Exhibit 1.1 illustrates revenues of OHA for FY1999-2000 through FY2002-03.

**Exhibit 1.1
Office of Hawaiian Affairs: Revenues FY1999-2000 through FY2002-03**

Revenues	FY1999-2000	FY2000-01	FY2001-02	FY2002-03
Appropriations	\$2,550,922	\$2,519,663	\$2,619,663	\$2,532,663
Public land trust	8,238,109	8,261,921	6,535	17,543,804
Dividend and interest income	10,798,857	11,465,433	11,411,538	8,352,150
Native Hawaiian Rights Fund	85,611	135,406	0	0
Federal and other grants	254,051	2,210,794	0	0
Newspaper ads	35,024	28,284	85,362	44,696
Donations and other	88,767	71,362	22,046	158,557
Non-imposed fringe benefits	134,677	111,305	104,429	150,815
Total Revenues	\$22,186,018	\$24,804,168	\$14,249,573	\$28,782,685

Source: Office of Hawaiian Affairs FY1999-2000 through FY2002-03 financial statements prepared by Deloitte & Touche LLP.

In FY2000-01, OHA received over \$8.2 million from the public land trust; in FY2001-02, the agency received only about \$6,500 from the trust. This sharp decrease was precipitated by a decision of the Hawai'i Supreme Court. In September 2001, the court held that certain

provisions of state law setting forth the means by which revenues from the public land trust are to be paid to OHA conflict with federal law and therefore are invalid. This decision resulted in the dismissal of OHA's claim for a pro rata share of revenues derived from: (1) that portion of the Honolulu International Airport that sits on ceded lands; (2) Hilo Medical Center patient services receipts; (3) receipts from the Hawai'i Housing Authority and the Housing and Community Development Corporation of Hawai'i for projects situated on ceded lands; and (4) interest earned on such withheld revenues. OHA has recently begun to receive a portion of the undisputed trust revenues. The portion in FY2002-03 amounted to \$17,543,804 and includes revenue due from FY2001-02.

The organization

The State Constitution requires that a board of trustees, of at least nine members who are Hawaiian and elected by Hawaiians, govern OHA. O'ahu, Kaua'i, Maui, Moloka'i, Lāna'i, and Hawai'i each must have at least one representative on the board. Currently, the board has nine trustees who were elected to serve staggered four-year terms.

In February 2000, the U.S. Supreme Court held that OHA's electoral qualification based on ancestry is a violation of the U.S. Constitution's Fifteenth Amendment. Under the amendment, both the national government and states may not deny individuals the right to vote on account of race. As a result of this decision, the entire state electorate is now eligible to vote for trustee candidates.

In 2002, the Court of Appeals of the Ninth Circuit also invalidated the limitation of eligibility to be a candidate for OHA trustee to "Hawaiians." The court based its decision on the Voting Rights Act, as well as the U.S. Constitution's Fifteenth Amendment. Thus, at present, both "Hawaiians" and "non-Hawaiians" may qualify as candidates for the office of OHA trustee.

OHA's board is a policy-making body. As required by law, the board appoints an administrator who serves as the agency's principal executive. The administrator is responsible for executing board policies, carrying out the agency's goals and objectives, and managing agency operations. The administrator hires all agency personnel, excluding the staff assigned to trustees. For FY2002-03, OHA had 114 positions, nine of which were vacant.

The administrator is responsible for the overall management of the administrative functions of OHA. Under a FY1998-99 reorganization, a former administrator consolidated ten divisions within the office into three functional operating centers: Administration, Program Systems Group, and Hawaiian Rights. In FY2003-04, the agency reorganized

again and now consists of three major areas: Administration, Operations, and Beneficiary Advocacy and Empowerment. Exhibit 1.2 displays OHA's organizational structure approved in December 2003.

Entities reporting directly to the administrator include the Washington D.C. Bureau, the Halawa Luluku Interpretive Development Project, the Beneficiary Advocacy and Empowerment unit, the Operations unit, and Treasury and Other Services, and Support Services.

The deputy for beneficiary advocacy and empowerment has full responsibility for directing and managing programs and efforts to meet the goals and objectives of the agency's strategic plan. The deputy oversees four major *hale* (literally, "house" or "houses") separated by functional areas. These include the Hawaiian governance *hale*; the health, human services, housing, and education *hale*; the economic development *hale*; and the native rights, preservation, culture, and land *hale*.

The deputy administrator for operations supervises an office of board services; office of legal services; human resources office; community resources section; public information and communications office; government relations and legislative affairs office; and planning, evaluation, research and grants *hale*.

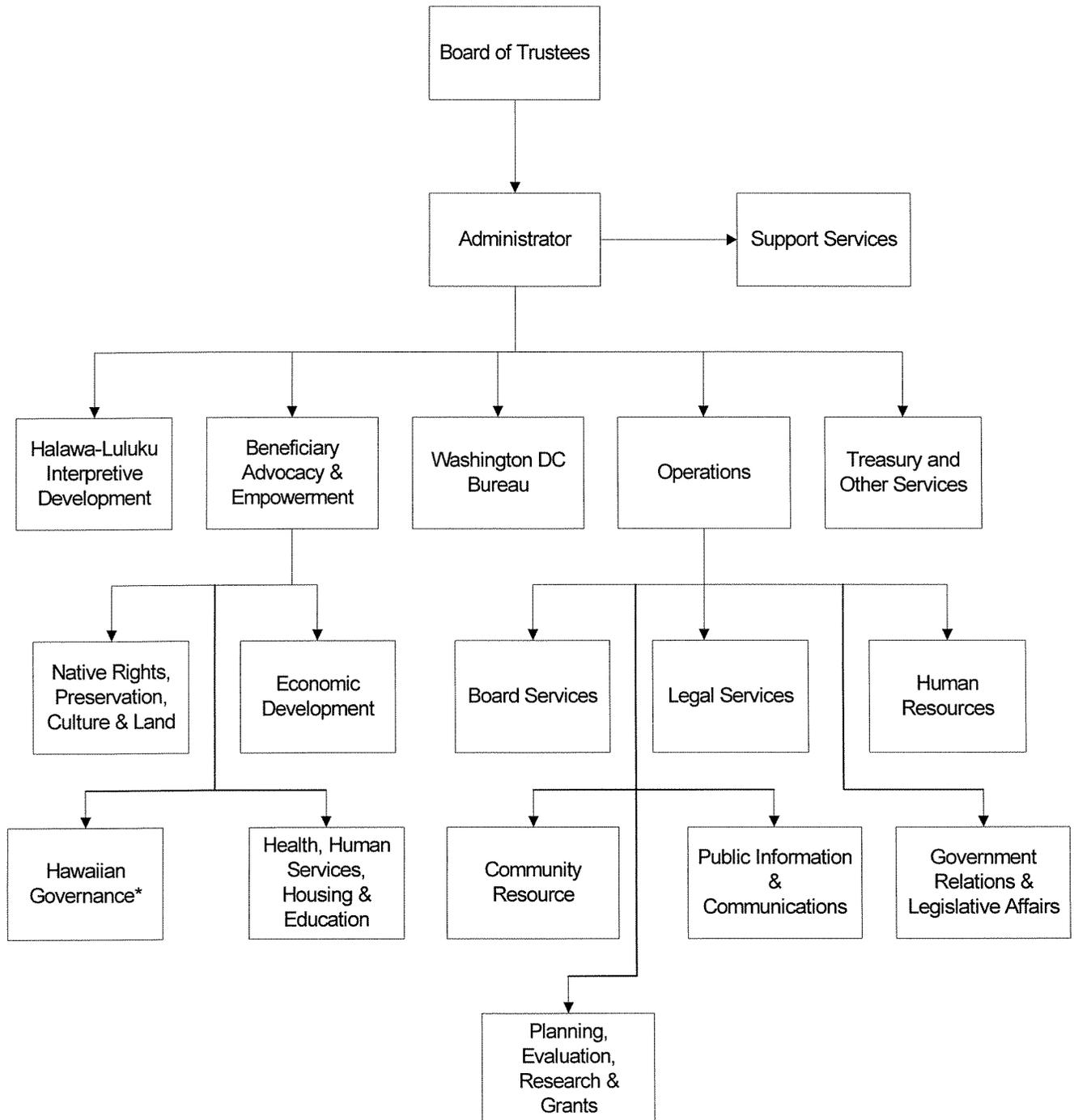
The treasury and other services unit handles functions such as management information systems and accounting, support, and treasury services.

Services provided and related expenditures

OHA provides economic development, educational, health care, legal representation, and housing services to native Hawaiians and Hawaiians. These services are provided directly by OHA staff, through contracted services, or by financial support to agencies providing services to native Hawaiians and Hawaiians. Some of the programs supported by OHA include the traditional Hawaiian diet program through the Waianae Coast Comprehensive Health Center; a traditional Hawaiian diet research project through the Department of Health; and a multi-service system project to provide statewide information and referral, technical assistance, and follow-up through Alu Like, an organization funded by OHA to provide programs and services to native Hawaiians and Hawaiians.

In the area of housing and community development, OHA administers a home ownership program in partnership with Fannie Mae, First Hawaiian Bank, and the Bank of Hawai'i, and provides assistance and subsidies for self-help housing and a homesteader loan program. The

Exhibit 1.2
Office of Hawaiian Affairs Organizational Structure
 Approved December 2003



* This program reports directly to the administrator.

Source: Office of Hawaiian Affairs

agency also administers an individual development account program through an administrative grant to Alu Like. This program provides a dollar-for-dollar match to low-income beneficiaries interested in saving for college, home ownership, home repair, and business capitalization and entrepreneurship. In addition, funded by OHA, the Hawai'i Alliance for Community Based Economic Development trains beneficiaries and provides technical assistance to native Hawaiian non-profit organizations for economically based programs.

Under its education program, OHA provides funding to the University of Hawai'i at Hilo for gifted and talented native Hawaiian children on Kaua'i, O'ahu, Moloka'i, Lāna'i, Maui, and Hawai'i. The agency provides tutorial grants to public schools and community school associations. The agency also provides funding to the Department of Education for a Hawaiian language immersion program in public schools. In addition, the agency provides support to the Merrie Monarch Festival and the Kalihi Valley Education Center.

OHA also administers the Native Hawaiian Revolving Loan Fund program by providing entrepreneurial training, assistance, and lending to native Hawaiian-owned businesses that are unable to secure financing through conventional lending sources. During FY2001-02, OHA approved nine loans totaling \$398,000 and disbursed seven loans totaling \$340,000, and created 20 jobs through the use of moneys in its Native Hawaiian Revolving Loan Fund.

Exhibit 1.3 illustrates OHA's expenditures for FY1999-2000 through FY2002-03.

Planning role

OHA has a broad statutory mandate. Although it is but one state agency among many in our state government, OHA is tasked with oversight of any program, public or private, that serves Hawaiians. That oversight involves knowing its beneficiaries and all federal, state, county, and private programs and services now available to native Hawaiians and Hawaiians. It also involves developing a comprehensive master plan for the betterment of conditions of native Hawaiians and Hawaiians, assisting in the development of state and county agency plans for programs and services for Hawaiians, and maintaining an inventory of federal, state, county, and private programs and services for Hawaiians.

Recent efforts towards nationhood and a Hawaiian government

The establishment of a native Hawaiian government has been an important issue deliberated by OHA and the larger Hawaiian community for a number of years. To OHA, this issue has become much more urgent in recent years due to an increasing number of legal and political challenges against native Hawaiian rights and entitlements. The need to

Exhibit 1.3
Office of Hawaiian Affairs: Expenditures FY1999-2000
through FY2002-03

Expenditure	FY1999-2000	FY2000-01	FY2001-02	FY2002-03
Board of Trustees	\$4,140,183	\$6,714,551	\$4,038,380	\$909,946
Administration	5,051,461	4,204,944	5,532,063	12,415,213*
Program systems group	5,239,645	6,362,190	5,953,174	0
Hawaiian rights	2,288,992	1,927,954	2,321,840	0
Capital outlay	359,715	0	0	0
Depreciation	0	0	332,174	536,556
Total Expenditures	\$17,079,996	\$19,209,639	\$18,177,631	\$13,861,715

* Note: The expenditures for FY1999-2000 through FY2001-02 are categorized by the previous organizational structure. Expenditures for FY2002-03 are grouped under administration but include \$6,788,640 for Support Services unit and \$5,626,573 for Beneficiary Advocacy and Empowerment unit. These organizational units were created by the administrative reorganization in 2003.

Source: Office of Hawaiian Affairs FY1999-2000 to FY2002-03 financial statements prepared by Deloitte & Touche LLP.

facilitate a process for forming a Hawaiian nation has long been recognized by OHA and is included in its recently formulated 2002 strategy. According to Goal 6, "By 2007, OHA shall have assisted, coordinated, and enabled the creation of a unified Hawaiian nation." To implement this strategic plan, OHA created a new Hawaiian governance *hale* to begin an information-sharing phase with the community and to report back to the Board of Trustees with recommendations on how to proceed with its six-phase process for creating a native Hawaiian government. These six phases for the 2004 fiscal year include:

1. Sharing information with the community;
2. Addressing the issue (conducting Hawaiian delegate election, research, and media);
3. Calling for candidates;
4. Electing representatives;
5. Convening an *`aha* (constitutional convention); and
6. Ratifying the process.

Separate from OHA's efforts to establish a native Hawaiian government, the agency is also supporting the passage of a federal bill (S. 344) that, among other purposes, expresses the United States' policy regarding its relationship with native Hawaiians and provides a process for U.S. recognition of a native Hawaiian governing entity. The bill is popularly known as the Akaka bill. If passed, this bill would provide a process within the framework of federal law for the native Hawaiian people to "[e]xercise their rights as indigenous people to reorganize a native Hawaiian governing entity for the purpose of giving expression to their rights as native people to self-determination and self-governance."

Previous Audit Reports

Our most recent audit of the agency found that the board allowed OHA's master and functional plans to remain outdated. We recommended that the board focus its attention on identifying the agency's role in improving the conditions of all Hawaiians, on fulfilling its fiduciary duties, and on improving its management of OHA's investments. In addition, our 2001 audit reported that the agency did not ensure that funds disbursed from its grant and Native Hawaiian Revolving Loan Fund programs were well spent. Many of our earlier audit findings were also echoed in audits conducted by independent auditors contracted by OHA.

Objectives of the Audit

1. Assess whether the Office of Hawaiian Affairs ensures its resources are used to provide programs and activities that meet the needs and improve the conditions of native Hawaiians and Hawaiians.
2. As appropriate to the current audit, assess whether the Office of Hawaiian Affairs has addressed our previous audits' findings and recommendations.
3. Make recommendations as appropriate.

Scope and Methodology

Our audit examined OHA's management of its program services, financial operations, and human resources to meet the needs of its beneficiaries during FY2002-03. We assessed the agency's efforts to address significant findings and recommendations from previous audits as they relate to our current audit's objectives.

Our review included OHA's efforts to: identify and plan for the needs of native Hawaiians and Hawaiians since issuance of our last audit report in 2001; solicit input from the Hawaiian community to determine the needs

of its beneficiaries; and monitor the effectiveness of its programs to ensure that conditions of native Hawaiians and Hawaiians are improved.

We reviewed pertinent state and federal laws and rules, policies and procedures, program plans, and operation manuals. We also reviewed judgmentally selected expenditure reports, investment reports, records on grants, Native Hawaiian Revolving Loan Fund disbursements, and contracts. We attended board meetings and interviewed each trustee, the administrator, judgmentally selected staff, and representatives of other agencies involved with OHA.

We procured the services of a financial consultant, KPMG LLP, to review OHA's management of its investment portfolios. The consultant reviewed documentation, reports, and other information detailing management's control, as established by OHA and its Board of Trustees, over the investments held in the Native Hawaiian Trust Fund. Chapter 3 comprises the consultant's findings and recommendations.

We conducted our audit from November 2003 through May 2004 according to generally accepted government auditing standards.

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Chapter 2

The Office of Hawaiian Affairs Still Lacks Some Basic Tools Necessary for Effective Leadership

Our last audit of the Office of Hawaiian Affairs (OHA) was issued in March 2001. Three years later, we find that OHA is still ill-equipped to fulfill its fiduciary duty. OHA has yet to complete a comprehensive master plan marshaling statewide resources to improve the conditions of native Hawaiians and Hawaiians.

Although OHA has recently developed its own strategic plan for 2002-2007, we note that a strategic plan should have derived from a master plan that identifies the needs of native Hawaiians and Hawaiians. A strategic plan that lacks the underlying foundation and vision of a master plan lacks adequate direction. In addition, we found that the strategic plan's implementation has shortcomings and its goals are not being systematically brought to fruition.

OHA continues to struggle internally with organizational, personnel, and fiscal issues. Despite the recommendation of our last audit—to properly plan for any contemplated organizational change—OHA has once again reconstituted itself without the requisite planning, resulting in confusion among its staff. In addition, the agency's human and organizational resources have been disrupted by changes in leadership, personnel, and programs, and OHA lacks the policies and procedures needed to guide the newly reorganized agency. Overall, since our last audit, OHA has shown little improvement in its ability to serve Hawaiians.

Summary of Findings

1. The Board of Trustees still has not provided the State with a comprehensive master plan for bettering the conditions of its beneficiaries.
2. OHA is still grappling with the effects of poorly planned reorganizations.
3. OHA's casual administration of its finances does not demonstrate respect for its fiduciary duty to all Hawaiians.

The Board of Trustees Still Has Not Provided the State With a Comprehensive Master Plan For Bettering the Conditions of Its Beneficiaries

Section 10-6, HRS, makes OHA responsible for assisting state and county agencies in developing plans and activities for native Hawaiian and Hawaiian services. This plan is critical because it is intended to guide the State's efforts to better the conditions of all Hawaiians by identifying the basic needs of beneficiaries, immediate and long-range goals, priorities and alternatives for program implementation, and an organization of administrative and program structure. In our 1993, 1997, and 2001 audits, we recommended that OHA develop a comprehensive master plan. Although OHA agreed and has long recognized the need for such a plan, to date and over a decade since our initial recommendations in 1993, a comprehensive master plan remains elusive.

In our 2001 audit, we noted legislative efforts to move OHA toward completion of a comprehensive master plan. In 1989, the Legislature requested the establishment of a governor-appointed task force to identify available services and critical needs of Hawaiians and to recommend ways to improve service accessibility and coordination. The task force, then known as Hui `Imi, was later commended and reauthorized by the 1997 Legislature as the Hui `Imi Advisory Council. It was placed for administrative purposes within the Department of Accounting and General Services and was neither attached to nor part of OHA. Further, it was intended to be temporary, with a sunset date of June 30, 2004.

By law—Section 10-18, HRS—the Hui `Imi Advisory Council comprises 20 or so organizations and representatives of any other entity “that expresses interest to participate” All members are volunteers serving without compensation. The council as a whole has no permanent staff, although its administrative expenses are defrayed by appropriations made to the advisory group. The first such appropriation was made in 1999 when the Legislature underscored the importance of a comprehensive master plan for Hawaiians. With general and trust fund appropriations of over \$62,500, the 1999 Legislature directed OHA to develop a comprehensive master plan by collaborating with other agencies serving Hawaiians, most of whom were statutorily named members of the Hui `Imi Advisory Council. The deadline for public distribution of a master plan was December 31, 2000. The deadline was not met.

The Hui `Imi Advisory Council was active, however. The council drew up an action plan in which completion of a comprehensive master plan was identified as one of the many council outcomes. The action plan, which was submitted to the Legislature in December 2002, includes the council's mission statement:

The Hui `Imi Advisory Council finds that there is a need for a coordinative mechanism to improve the provision of services to Hawaiians; to encourage better coordination among diverse organizations and agencies in both the public and private sectors; to encourage prudent use of resources; and to guide the future development of the Hawaiian community.

The plan lists five goals established by the council to fulfill its mission:

1. To serve as a coordinating body for organizations and agencies in the public and private sectors serving Hawaiians;
2. To implement activities that build capacity and meet the needs of Hawaiian communities as recommended by the Hui `Imi;
3. To share, among its members, actions and programs implemented within Hawaiian communities;
4. To identify and gain support of decision-makers whose cooperation and resources are needed to fulfill the goals of the Hui `Imi;
5. To conduct forums in which Hui `Imi members conceive and implement common strategies to empower individuals to lead their own communities toward self-sufficiency.

Each goal has specific action steps identified with *kuleana* (responsible agency), a timeline, and cost items. Goal 5 lists completion of a comprehensive master plan as an outcome under the *kuleana* of the Hui `Imi leadership.

In 2003, the Legislature preempted the council's June 30, 2004 sunset date, thereby making it permanent, and moved the council to OHA for administrative purposes. By then, however, the council had not met regularly since 2002 and the comprehensive master plan remains a "document in development," according to OHA staff. Logistical issues plagued the council and contributed to its inability to move forward with its work on the plan. Such issues included the difficulty of convening uncompensated officials that must, by law, be represented; lack of permanent staff or of personnel support by OHA; and uncertainty of the status of the council after the 2003 departure of its chair who was also an employee of OHA. In the end, the Hui `Imi Advisory Council was unable to complete the comprehensive master plan.

The Board of Trustees is ultimately responsible for the plan

The Hui `Imi Advisory Council may have assumed the task of completing a comprehensive master plan. Nonetheless, the statutory duty “to develop, implement, and continually update a comprehensive master plan” remains with the OHA Board of Trustees. And the board was charged with this duty over 25 years ago. If the trustees’ duty to develop a comprehensive master plan is to be fulfilled through the council’s efforts, administrative and leadership support ought to be forthcoming from the board. The trustees should partner with the council and lessen the council’s administrative and logistical burdens.

Moreover, other goals set for itself by the Hui `Imi Advisory Council also mirror the Board of Trustees’ statutory duties. The aims of both the board and the council are to assist other organizations in serving all Hawaiians, to serve as a clearinghouse of programs and services available to all Hawaiians, and to be a catalyst for new programs and activities for all Hawaiians. Their congruent aims behoove the board to partner with the council and support it administratively, especially in light of OHA’s emphasis on nationhood and less on direct services to beneficiaries. We discuss OHA’s goals and its 2002 strategic plan in detail below.

Although a strategic plan has been developed, the urgent need for a comprehensive master plan still remains

OHA embarked on a strategic planning process in 2001, expecting that its strategic plan, synthesized with the strategic plans of other agencies, would serve as an impetus for a renewed effort toward a comprehensive master plan in FY2002-03. As we found, however, such a renewed effort did not take place during that period. Moreover, we note that a strategic plan should build on a master plan, not the converse. It is not surprising, then, that the strategic planning process did not yield the hoped for result.

Completed in 2002, the strategic plan lays out the agency’s efforts to meet the needs of its beneficiaries. According to OHA’s own planning concept, this document is to serve as the basis for the agency’s program planning and budgeting. Ten major goals are identified in the strategic plan generally covering: (1) native rights advocacy; (2) culture; (3) economic development; (4) education; (5) environment and natural resources; (6) nationhood; (7) policy; (8) social services; (9) land and housing; (10) and health.

Each goal has specific strategies (see Appendix A). Each strategy in turn is described and justified with a specific objective articulated. The strategy is further fleshed out with a desired outcome, specific activities to achieve that outcome, location of these activities, required agency staff and other partnering organizations, a timeline, cost-generating items (but no cost estimates), and performance measures. Overall, OHA has heightened its goal of enabling the creation of “a unified Hawaiian

nation.” It has established an office in Washington, D.C., “to increase support for issues important to Native Hawaiians and secure passage for favorable legislation at the national level.” The board has also allocated \$2.2 million for FY2003-04 toward the agency’s nationhood goal.

Establishing priorities, articulating goals, and translating them into action plans are essential undertakings for effective leadership, and OHA is commended for developing a strategic plan. As the agency recognizes, however, strategic goals rely on a comprehensive master plan as the foundation. OHA, and other government and private agencies, are making strategic decisions without a foundation of basic demographic data, basic beneficiary needs, and a shared understanding of immediate and long-range goals for the betterment of conditions of all Hawaiians—all elements of the comprehensive master plan contemplated by the Legislature.

OHA Is Still Grappling With the Effects of Poorly Planned Reorganizations

In our 2001 audit, we found that an on-going reorganization by the OHA administrator had led to a state of crisis. Inadequate planning for organizational change resulted in hasty decisions, which negatively impacted employee morale and resulted in assigning staff to positions for which they may not have been qualified. Moreover, the lack of an employee grievance process to address employee concerns resulting from the poorly planned reorganization provided employees with few options besides resignation or civil action. In fact, approximately half of the former division officers had resigned. One former employee’s resignation letter stated that OHA had become ineffective because of the loss of good personnel.

In our current audit, we found that OHA is still reeling from this poorly planned reorganization, and from yet another reorganization in 2003. During FY2001-02 and FY2002-03, OHA hired a combined total of 43 new employees to fill a variety of positions, including key managerial positions; the agency has a total of 114 positions. While OHA is in the process of transforming itself, training new staff, and addressing new and complex issues, comprehensive and continuously updated policies and procedures and related management documents are critical to guide organizational change. Although our 2001 audit recommended adoption of such policies and procedures, these basic guides are still lacking.

Strategic plan lacks specificity, contributing to confusion over priorities

We found, through interviews with *hale* directors, that there was a consistent understanding that the strategic plan serves as the basis for action plans. However, the directors also noted uncertainty about how the priorities identified in the strategic plan are to be translated into a budget. Under yet another reorganization in 2003, the Beneficiary

Advocacy and Empowerment unit of OHA directs and manages the programs intended to meet the goals of the agency's strategic plan. Each of the four *hale* comprising this unit addresses certain functional areas and is headed by a director.

At the time of our fieldwork in early 2004, each director had only recently been installed—from three to six months earlier. From interviews with each director, we found inconsistent understandings of how program priorities are established and translated into budgets. Each director acknowledged the strategic plan established program priorities; however, they had varying ideas among them about the budgeting process: one was “not really sure how OHA budgets”; two other directors told us they did not know how program priorities are budgeted for, but one of them revised his understanding in a follow-up response, informing us that he estimated budget requirements based on the activities in the strategic plan; and another based his budget on the activities set forth in the strategic plan.

The strategic plan itself is not instructive on *how* to budget, although it does set forth generally the activities mapped for each strategy. Nor does the plan inform directors on the process by which these activities are to be parsed into tasks, timelines, and resource and budget requirements—much less, that this process is necessary. Without adequate guidance, particularly for new directors, there can be no expectation that the budget will support the action plans needed to realize the goals of the strategic plan.

Organizational chart and functional statements are inconsistent

We found inconsistencies in the agency's organizational chart and functional statements that confuse lines of authority or portray staffing schemes differently. We reviewed organizational charts and functional statements dated December 2003 reflecting the agency's reorganization that year. The four *hale* that house the agency's substantive programs are shown graphically in the organizational chart as part of the Beneficiary Advocacy and Empowerment unit headed by a deputy administrator; however, an exception noted on the chart for the Hawaiian Governance *hale* indicates that the *hale* reports directly to the administrator. The Washington D.C. Bureau, according to the functional statement, is within the Hawaiian Governance *hale*. However, in the agency's organizational chart, the bureau is depicted as a stand-alone unit reporting directly to the administrator.

On the administrative services side, the Office of Board Services provides support services to the Board of Trustees. Its staffing scheme in the functional statements lists Board Services & Record Management, Planning & Research, Facilities Management, and Beneficiary Services. The organizational chart depicts an equivalent Facilities Management

subunit, a Hawaiian Registry subunit, an Intake and Referral Division, and a Records Management Division; no Planning & Research subunit is shown. We could only match up, by position numbers shown in both documents, the Beneficiary Services (in the functional statements) and the Hawaiian Registry subunits and Intake and Referral Division (in the organizational chart). With the exception of the Facilities Management subunit, other subunits could not be similarly equated. The Planning & Research subunit is mentioned in the functional statements, but not shown at all in the organizational chart for the Office of Board Services.

The inconsistencies between the organizational chart and the functional statements diminish OHA's organizational efficiency and effectiveness. As we found with the reorganization that took place during our prior 2001 audit, OHA should have planned for, documented, and reviewed its proposed 2003 organization *prior* to actual implementation. OHA should have ensured that the organizational chart and functional statements were properly aligned. As OHA changes itself, the agency's staff—particularly the new *hale* directors—labor without clear organizational definition and specific guidance on implementing the agency's strategic plan.

OHA's Casual Administration of Its Finances Does Not Demonstrate Respect For Its Fiduciary Duty to All Hawaiians

In our prior audit, we found that inadequate controls over trustee expense accounts, the protocol fund, and petty cash account resulted in the loss of funds through gross misuse by some trustees. We had reviewed trustee expense reports for calendar years 1996 through 1999 and found numerous questionable transactions that did not appear to meet the purpose of the trustee expense account. For example, two trustees had used their allowances to make interest-free personal loans exceeding a combined total of \$8,000 to themselves and family members.

Additionally, we found that some trustees had used the protocol fund for questionable expenses such as \$1,000 in payments for a beneficiary's dentures and \$200 to pay for a former trustee's legal fees.

In our current audit, we again note possible abuse of protocol funds, petty cash, and trustee expense accounts. The vagueness of certain policies and procedures promotes the potential for abuse and creates a culture incongruous with the trustees' duty of loyalty to all beneficiaries. In addition, without tighter oversight over its Native Hawaiian Revolving Loan Fund Program, the agency is not preventing deterioration of the financial condition of loan recipients.

The purpose of certain protocol expenditures does not demonstrate loyalty to all beneficiaries' interests

OHA's Administrative and Financial Manual of Guides provides that the purpose of its protocol fund is "to cover the expenses of social occasions hosted by OHA as a whole, the observance of Hawaiian culture at social and business conventions, and other social occasions authorized by the Chairperson." No moneys are to be expended from this fund "except upon the approval of the Chairperson." The provisions in the manual regarding the protocol fund are found under Title 1, which is entitled *Trustee Compensation and General Allowances*.

We were informed during the course of the audit that OHA no longer maintains a protocol fund per se. Rather, a line item for protocol expenditures is included in the agency's budget. In addition to this line item, we learned that a separate amount is also budgeted for the administrator's use at his discretion for the same purposes as trustee protocol expenditures.

We reviewed the expenditure report of FY2002-03 protocol expenses and selected for follow-up 25 disbursements totaling \$12,680 that appeared questionable in light of the manual's stated purpose for its "protocol fund." We found disbursements totaling \$5,715 to pay for gifts to staff or trustees and \$2,493 to pay for internal office events, including farewell luncheons and a staff awards ceremony. One of the farewell luncheons was held for an independent contractor who continues to provide services to the office. We also found a protocol expenditure of \$89 for a microwave oven to be used by staff.

These expenditures mar the duty of loyalty owed by OHA to all beneficiaries. An expansive interpretation of the manual's stated purpose could include the events associated with the disbursements reviewed. However, the beneficiaries of expenditures for internal office events (rather than those hosted by the office) are more directly OHA's staff and trustees, rather than its beneficiaries.

Policies and procedures for petty cash are not always followed

We reviewed the schedule of cash payments made during FY2000-01 to FY2002-03 and selected for further inquiry those petty cash payments that were not disbursed in accordance with established policies and procedures. We found more than \$800 in petty cash payments made without a receipt or any other documentation to support the expenditure. Also, an expenditure that exceeded the \$25 single disbursement limit was made without the approval of the administrator. Casual oversight of even small amounts of cash creates an environment enabling fraud and abuse.

OHA's manual of guides establishes management controls for safeguarding two categories of petty cash: office petty cash and an imprest, or in-house, checking account. The agency's main office and its

neighbor island offices each have an office petty cash fund containing up to \$100 in currency. The imprest checking account is maintained by the main office and has a balance of \$10,000.

The manual of guides limits single cash disbursements to \$25 from the office petty cash fund and to \$250 from the imprest checking account. However, the chairperson or the administrator may authorize a higher amount in the event of “hardship,” which is not defined. The manual also requires each disbursement to be supported by a related cash receipt, cash register tape, invoice, freight bill, or other original documentary evidence of disbursement. Furthermore, office petty cash disbursements are not allowed for any expenditure relating to payroll, out-of-state travel, training courses, or any payments required under a contract or other agreement. The manual, however, does not establish any such limitations for the imprest checking account.

We note uncertainty over which policies and procedures govern petty cash—Chapter 2 under Title 4 of the manual noted as approved by the board on October 23, 1991, or a document entitled *Office of Hawaiian Affairs, Office Petty Cash Fund, Regulations & Procedures* noted as revised January 1996. The staff attorney indicated that the 1996 revised procedures supersede Title 4; OHA’s controller, on the other hand, was “not certain” whether the later document superseded Title 4, but “would lean towards” the applicability of both documents.

Differences between certain provisions of the two documents beg for clarification. For example, under the earlier document, petty cash is to be replenished at the end of each quarter through the OHA comptroller; the later document calls for monthly replenishment through the administrator. The earlier document also places security responsibility with OHA; the later document entrusts “the custodian” with this responsibility. The earlier definition of “custodian” is the administrator’s designee; the revised definition names as custodian the community affairs coordinator (for neighbor island offices) or the accountant or account clerk (for the main office). Confusion over applicable policies and the responsible custodian creates a situation ripe for abuse.

***Trustee expenses
reflect inappropriate
use of funds***

Through our review of trustee expense accounts for FY2000-01 to FY 2002-03, we found that the same issues identified in our prior audit continue to exist. Previously, we had made note of questionable expenses and that certain trustees did not always return unspent annual allowances to OHA. In our current audit, we again found questionable transactions with unclear justifications. For example, one trustee’s expense of \$349 was a “Beneficiary Donation for a Moloka`i resident . . . to attend [a] meeting in California.” The justification for this donation

(the purpose of the expense as it relates to the agency's goals) is not clear. When asked about the expense, staff explained that they do not validate the strategic goal to which a trustee attributes any given purchase, since the allowance is assumed to support an administrative goal. In another example, a trustee listed a \$250 expense for a mobile lab for education at the "Very Special Health Fair 2003" in Kona. Again, the justification for this expense is unclear.

Other questionable expenses include staff lunches, office parties, and employee farewell gatherings. For example: \$23.12 was spent on breakfast for staff painting the office; \$200 was used for the employees' Christmas party; \$96.04 was expended on a secretary's day luncheon; and \$140.99 was spent on beverages and supplies for an employee's farewell gathering. Staff explained that costs for staff functions are acceptable expenditures of agency funds; however, it is unclear how paying for staff functions benefits beneficiaries or advances the agency's mission.

Similar to previous audit findings, we also found that certain trustees did not always return unspent annual allowances to OHA. For example, one trustee did not return unexpended allowances totaling \$2,705.38 for calendar years 2001, 2002, and 2003. After realizing that the funds should have been returned, staff informed us that the trustee has requested the assistance of the administrator in resolving issues with the past due balances.

Although each expenditure may be small in relation to the office's total budget, the spending reflects a complacent attitude towards money held in trust for beneficiaries. Again, we suggest that OHA should consider disbursing trustee annual allowances on an actual expenditure reimbursement basis. This would help to ensure that these funds are used only for allowable purposes and reduce the opportunity for misuse.

Tighter oversight of the Native Hawaiian Revolving Loan Fund is needed to prevent deterioration of loan recipients' financial condition

In our 2001 audit, we found deficiencies in the processing of Native Hawaiian Revolving Loan Fund loans and in collection efforts. Since then, OHA's staff has improved its loan processing: credit reports were ordered and reviewed and loan analyses were presented to the advisory board. However, significant delinquencies and inadequate collection efforts persist, suggesting deep-rooted problems with the administration of the program.

The Native Hawaiian Revolving Loan Fund is a federal lending program administered by OHA and supported by funds from both the federal Administration for Native Americans and OHA. To expand the entrepreneurial opportunities of Hawaiians, the fund offers business loans of \$75,000 or less on favorable terms to Hawaiians unable to secure conventional financing through traditional lending sources. The

Administration for Native Americans has contributed \$12.9 million to the loan fund and OHA has contributed an additional \$10 million as of 2003. An advisory board, approved by the Board of Trustees and confirmed by the U.S. Commissioner of the Administration for Native Americans, approves the loans. The first loan was approved in September 1989 and by the end of FY2001-02, the loan fund had approved 415 loans, for an average of 30 loans per year. This number has recently declined with a total of seven loans disbursed during FY2002-03.

The Native Hawaiian Revolving Loan Fund program continues to experience high delinquency and default rates. As of January 31, 2004, there were 121 loans outstanding for a total of \$3,330,353. Of the 121 loans outstanding, 62 were in default, meaning payments on the loan had stopped altogether, and 20 were delinquent, meaning that payments were continuing, but behind. Defaulted and delinquent loans total \$2,429,134, or 72.9 percent, of all outstanding loans. Loan collection efforts continue to lack rigor. As a result, the Native Hawaiian Revolving Fund continues to lose resources that future Hawaiian entrepreneurs could benefit from.

Program creators acknowledge that the Native Hawaiian Revolving Loan Fund assumes a higher risk exposure since applicants must have been denied access to conventional lending. It is incumbent on OHA, as the Native Hawaiian Revolving Loan Fund administrator, to mitigate that risk by closely monitoring the status of loans and providing guidance to clients through specialized training and technical assistance. According to OHA, monitoring includes regular financial reports and scheduled telephone contact and site visits.

We reviewed OHA's monitoring efforts and found irregular financial reporting and client contacts. A March 2004 Single Audit Report by Deloitte and Touche LLP suggests the lack of regular financial reporting is caused generally by an inability of the borrower to produce financial statements, and that OHA should assist borrowers in this area.

We also found that training and technical assistance are focused on loan application preparation. While OHA requires each applicant to attend entrepreneurial training and to create a business plan, the advisory board has recognized the client's need for post-loan disbursement assistance, requiring its provision as a condition of many loans. There is, however, no systematic tracking of post-loan disbursement training and technical assistance to ensure clients are receiving the services needed.

The program has been disbursing loans for nearly 15 years, yet OHA has not studied the attributes of successes and failures to better predict loan outcomes and to identify those areas in which loan recipients could

benefit from training or other assistance. The program may have improved the condition of some Hawaiians by providing them additional funding for successful business and employment opportunities for Hawaiians. However, given the number of loans that have fallen into default or delinquency, the program has arguably worsened the condition of loan recipients, by saddling them with debt they cannot manage. Ultimately, program losses should be mitigated by program evaluation and improvement designed to safeguard federal and OHA funds intended to expand the entrepreneurial opportunities of all Hawaiians.

Conclusion

After being in existence for over 25 years, the Office of Hawaiian Affairs continues to operate like a fledgling agency. The constitutionally and statutorily identified leader of the Hawaiian community has yet to present the State with a comprehensive master plan to marshal public and private resources to better the conditions of all Hawaiians. It is still struggling to put its own house in order and remains casual in the administration of the funds over which it has a fiduciary duty of loyalty to its beneficiaries. Overall, OHA has shown little improvement in meeting its obligation to improve conditions of all Hawaiians. Until it focuses on development of a comprehensive master plan as a priority, OHA's leadership role and trust obligations to its beneficiaries will remain unfulfilled.

Recommendations

1. The Board of Trustees of the Office of Hawaiian Affairs should resurrect efforts to develop a comprehensive master plan and provide administrative support for this effort, either internally or through the Hui `Imi Advisory Council, or both.
2. The Office of Hawaiian Affairs should:
 - a. Develop the appropriate management tools to guide implementation of its strategic plan, including but not limited to policies and procedures on action planning and budgeting and organizational charts consistent with its functional statements;
 - b. Revise its Administrative and Financial Manual of Guides to clarify the purpose of expenditures made from petty cash, protocol allocations, and trustee allowances, to require appropriate support for all such expenditures, and to convert payment of trustee expenses to a reimbursement arrangement; and

- c. Provide tighter oversight of loans made from the Native Hawaiian Revolving Loan Fund to prevent the financial deterioration of loan recipients, such oversight to include but not be limited to the provision of training and technical assistance to loan recipients, both pre-loan application and post-loan disbursement.

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Chapter 3

Despite Some Improvements, Continuing Deficiencies in the Office of Hawaiian Affairs' Investment Management Oversight Do Not Ensure Compliance With Its Fiduciary Obligations

As consultants on this audit, we reviewed documentation, reports, and other information detailing management's control, as established by the Office of Hawaiian Affairs (OHA) and its Board of Trustees, over the investments held in the Native Hawaiian Trust Fund. This chapter presents the results of our review.

KPMG LLP

Background

As of December 31, 2003, OHA had long-term invested assets of \$320.6 million in the Native Hawaiian Trust Fund (trust fund). Exhibit 3.1 illustrates OHA's long-term investments as of December 31, 2003. OHA, in keeping with its duties under the Hawai'i Uniform Prudent Investor Act, as codified in Chapter 554C, Hawai'i Revised Statutes (HRS), has diversified its investments into a number of asset classes including:

Domestic Large Cap: represents common and preferred stock interests in U.S. corporations, each with market capitalization generally greater than \$2 billion.

Domestic Small Cap: represents stock interests in U.S. corporations, each with total market capitalization generally less than \$2 billion.

International Equity: represents common and preferred stock interests in companies incorporated outside the United States.

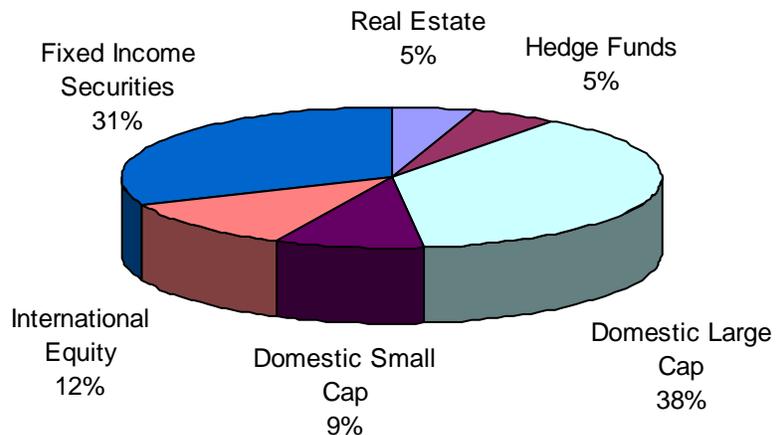
Fixed Income Securities: are debt instruments issued by corporations or federal governments that generally produce income in the form of coupon payments.

Real Estate: represents equity positions in publicly traded real estate investment trusts.

Hedge Funds: represents investment in limited liability structures that utilize various trading and arbitrage strategies with the objective of

producing consistent and relatively stable return streams not similar to other asset classes.

Exhibit 3.1
OHA's Long-term Investments
December 31, 2003



Source: Office of Hawaiian Affairs
Native Hawaiian Trust Fund Assets as of December 31, 2003 - \$320.6 million USD

OHA's long-term assets are managed by a number of external investment managers. These investment managers are evaluated and retained by two investment advisors, or manager of managers. Started by OHA in February 2003, this practice represents a material change in the office's investment process and oversight. Prior to retention of the investment advisors, OHA identified separate money managers for each asset class included in long-term investments, performed due diligence, and retained, monitored, and evaluated each investment manager. The Board of Trustees, in late 2002, decided that retaining external experts, or investment advisors, would be more prudent. The investment advisors would evaluate and select managers and create efficient and well-diversified portfolios for OHA. The office evaluated five candidates and selected Frank Russell Trust Company (Frank Russell) and Goldman Sachs Asset Management Company (Goldman Sachs) as its investment advisors (Frank Russell and Goldman Sachs, collectively referred to as the advisors). OHA's long-term portfolio was divided between the advisors equally. Hiring the advisors was completed in conjunction with revising the investment policy statement and conducting a new asset allocation study.

Currently, the spending policy of OHA allows for utilizing 5 percent of the three-year moving average of the portfolio's market value. Ceded land revenue payments received from the State of Hawai'i are considered additions to principal in determining the portfolio's market value, but are

utilized before any securities are liquidated to meet OHA's current operational needs. This practice has allowed the assets to continue to grow.

Summary of Findings

We found that OHA has taken a number of important and well-reasoned steps in investing its assets. It improved its investment policy statement, commissioned external experts to help formulate spending policy and asset allocation, and retained two well-respected firms with expertise in investment manager selection and oversight to address the more technical and detail-oriented aspects of the investment process. OHA hired an independent custodian to be responsible for the official books and records of the trust fund. OHA also performs monthly reconciliations of all assets and balances with the advisors, the custodian, and its own general ledger and supporting ledgers. The Board of Trustees meets quarterly with the advisors to review performance issues and evaluate opportunities and progress toward OHA's long-term objectives.

While OHA has looked to the advisors to help implement its overall investment strategy and to provide it with insight and ideas, two factors must be kept in mind: investment advisor independence and the board's continuing fiduciary duty regarding the trust fund. First, the advisors are not truly independent in terms of their relationship with OHA. Their compensation is based upon the value of assets OHA places under their control. They are motivated to increase the value of those assets on which their compensation is based and to select those solutions that best compensate their firms. Secondly, the use of experts to aid in the investment process is a prudent action by the Board of Trustees, but it does not relieve the board of its duties to ensure all aspects of the investment process continue to conform to OHA's investment policies and objectives.

Therefore, OHA should address two critical deficiencies:

1. OHA's investment policy statement and investment oversight procedures lack key components.
2. OHA's lack of advisor oversight prevents the Board of Trustees from receiving sufficient information to evaluate the investment advisors' performance.

OHA's Investment Policy Statement and Investment Oversight Procedures Have Improved, But Lack Key Components

An investment policy statement is a written document that outlines the objectives and policies of an investment portfolio. The statement should cover a broad array of components, from the delegation of responsibilities to the analysis of performance. OHA has revised and updated its investment policy statement numerous times to meet its changing needs. OHA's current investment policy statement was created under a team approach, with lead responsibility given to the consultant R.V. Kuhns and Associates and with input from the advisors and OHA's staff.

The current investment policy statement dated May 2003 incorporates many of the required components, including policies and directives on spending, asset allocation, permissible assets, staff roles, and responsibilities of the investment advisors and the custodians. However, certain key items are missing. By not addressing OHA's authority to set policy or identifying those statutes that control certain aspects of the investment process, the investment policy statement fails to ensure adequacy and completeness. The investment policy statement has neither identified key measurements to allow for evaluating the performance of the trust fund as a whole, nor set the appropriate standards for the actions of the Board of Trustees. Further, the investment policy statement does not address the use of more cost-efficient investments, such as index mutual funds (e.g., Vanguard 500 Index fund) whose performance mirrors its underlying index but for less cost than an actively managed fund, leading OHA to incur higher fees than its peer group. Finally, the current investment policy statement has not taken into account the nature of ceded land revenue payments in the asset allocation of the investments. These shortcomings reduce the efficiency of the trust fund as a whole, potentially depressing investment returns and leading to higher investment management costs.

Duties and responsibilities related to trust fund investments are not clearly laid out

The first requirement of an investment policy statement is to clearly document which parties have duties and responsibilities associated with the assets and how those duties are assigned. It should also incorporate all applicable laws and regulations. This process forces the consideration of all rulemaking regarding the assets. The investment policy statement should outline all aspects of oversight and fiduciary duties and document the history of the current environment, both legislative and procedural.

We reviewed the August 2000 Investment Policy Statement and the May 2003 Investment Policy Statement drafted by R.V. Kuhns and Associates and found that OHA's investment policy statement is missing this key information. The investment policy statement does not detail the authority of the Board of Trustees to set policy for the trust fund.

Specifically, Article XII, Section 5, of the State Constitution established the Office of Hawaiian Affairs to better address the requirements of Section 5(f) of the Admission Act of 1959. Act 196 (Session Laws of Hawai`i 1979) implemented Article XII by creating a new chapter in the Hawai`i Revised Statutes (HRS), which was later codified as Chapter 10. In addition, the investment policy statement does not detail the authority under which the fiduciaries define policy and procedures associated with the trust fund's investments, as outlined in Chapter 10, HRS, and expanded by Chapters 103 (Expenditure of Public Money and Public Contracts), 103D (Hawai`i Public Procurement Code), and 554C (Hawai`i Uniform Prudent Investor Act). Articulating the board's authority in the investment policy statement ensures that the processes and procedures it dictates coincide with the trust fund's regulatory environment.

Critical benchmarks for the trust fund have not been established for the investment advisors

Benchmarking is a key measurement process used to evaluate the performance of investment advisors and managers and a fiduciary's oversight of a pool of assets. The benchmarks should be selected to represent reasonable measures of the return and risk that the investment advisors and individual investment managers are expected to provide, as well as a means of measuring the decisions of the Board of Trustees to select investment advisors and to allocate the trust fund's investment.

The investment policy statement requires each investment advisor to manage according to a custom benchmark established by OHA. The inclusion of a custom benchmark in the investment policy statement allows the board to compare the performance of the advisors without bias. OHA's investment policy statement, however, does not define this custom benchmark. The investment policy statement allows the benchmark to be mutually agreed upon by OHA and the investment advisor. Each investment advisor has created its own benchmark. This practice is a deficiency that should be rectified by the board's establishment of the custom benchmark's formula and criteria. As is common in the industry, the benchmark is constructed by adding a percentage of the target return for each of the asset classes; the percentage reflects the exposure of the asset class proportionate to the total investment portfolio. For example, if the investment advisor has a 10 percent exposure to international stocks, the custom benchmark would contain 10 percent of the return of an international stock index. Similarly, if the investment advisor has a 30 percent exposure to fixed income securities, the custom benchmark would contain 30 percent of a fixed income index.

This process, however, highlights the need to have not one but two sets of custom benchmarks. The first set would weigh each asset class with the investment advisor's *actual* exposures to particular asset classes (if

the investment advisor has a 30 percent exposure to fixed income, the custom benchmark would have a 30 percent weight). This benchmark would highlight the investment advisor's expertise in selecting investment managers who can either meet or exceed the benchmark's performance.

The second set would weigh each asset class with the *target* exposure, not the actual exposure (if the target of the investment advisor is to have a 25 percent exposure to fixed income, the benchmark would only weigh fixed income by 25 percent, not the actual exposure of 30 percent). Both advisors took this approach in creating their custom benchmark. This benchmark would highlight the performance of the portfolio based on the asset exposure and help to explain the impact of having current exposures that differ from the target. This distinction is important especially where there is a material difference between an investment advisor's actual exposure and the stated target exposure. The difference in weights between the benchmark and the actual exposures is material enough to distort the true selection benefit of the advisors, and the differences are not consistent between advisors. OHA should understand whether the underperformance or overperformance of the trust fund's portfolio return was due to asset class exposure, which can be modified through the investment policy statement, or by each advisor's choice of investment managers.

Inconsistencies with current benchmarks make it difficult to compare the performance of the advisors

The current composite benchmarks used by the advisors present difficulties for OHA in evaluating each advisor's ability to select investment managers. The benchmarks do not allow OHA to evaluate the impact of asset allocation. The current advisor benchmarks are not consistent and differ enough to distort the true selection benefit of each advisor. Neither advisor's benchmark helps OHA to evaluate advisor decisions on eventual implementation of the long-term asset allocation.

Advisor benchmarks could be improved by incorporating use of actual weights or long-term target weights and by better selection of indexes. First, the long-term targets differ between the advisors and the investment policy statement. The weights should be adjusted to meet the investment policy statement. Second, the selection of indexes should be re-evaluated. Although the advisors have been given the same mandates, each uses different indexes for certain asset classes, thereby reducing OHA's ability to evaluate the advisor's performance. Also, certain indexes selected are not appropriate for the asset class. One advisor selected essentially a money market target for an asset class with substantially more risk. It is not surprising that this advisor has been

beating the index for each period evaluated. OHA, rather than the advisors, should select the indexes to ensure consistency among advisor benchmarks.

The lack of historical data and performance standards results in a material weakness

Setting a target for performance is key in investment management and oversight. Like any objective or goal, it must be realistic, timely, applicable, and measurable. In order to be realistic, all investment objectives must support the target. For example, it would be nearly impossible for a portfolio to perform in the top 10 percent of peers with an asset allocation that contains no equity exposure. Without equity exposure, portfolios could not benefit from the asset class with a leading 10.6 percent average stock market return since 1926, and would thereby underperform 90 percent of other portfolios that have equity exposure.

OHA has set a target objective for each investment advisor. Each investment advisor is expected to perform in the top 40 percent of similar investment advisors. The investment policy statement, however, does not set a target return for the trust fund as a whole. A target return would enable the Board of Trustees and OHA to evaluate board and OHA actions and investment decisions.

Moreover, lack of a target return prevents identification of the relative ranking of the trust fund's performance. We requested historical returns of the total trust fund in order to calculate returns and risk and compare the results to a relative peer universe. OHA staff was unable to provide historical information pertaining to investment returns of the trust fund. We consider this a material weakness. OHA should be able to provide the results of its investment performance.

Using quarterly trust fund balances beginning with September 1994, we calculated an approximate historical rate of return. While this process has shortcomings (period returns may be overstated or understated due to cash flow activity), it is a reasonable method to approximate the total return of the trust fund.

Over the last nine years, from January 1995 to December 2003, the performance of the trust fund ranked in the bottom 5 percent of public investment funds, with an annualized return of 7.33 percent. The median return of the trust fund's peers over the same time period was 9.87 percent. Interestingly, it was not the trust fund's asset allocation that led to the poor performance. Had the trust fund assets been invested in index funds equal to its target allocation (65 percent in U.S. equities and 35 percent in fixed income), the trust fund would have been in the top 10 percent of its peers, with an 11.3 percent return. Using this assumption,

we conclude that it was OHA's selection process and its inability to terminate underperforming managers that led to the substandard performance.

Poor performance was one factor leading to the change in process at OHA and retention of the advisors. During 2003, under the direction of the advisors, the trust fund had a return of 24.3 percent, which was better than 86 percent of other public investment funds.

OHA fails to address the use of passive investments in its investment policy statement

Currently, the investment policy statement requires funds to be actively managed by external investment management firms. Active management generally refers to the process of identifying and acquiring those securities that are expected to appreciate at a rate greater than the market as a whole. The active management requirement in the investment policy statement is the sole guideline directing this method of investment management. The investment policy statement does not explain OHA's reason for this requirement.

Successful active management is very difficult to achieve. According to a number of academic and industry studies, active management may underperform passive investment management over 70 percent of the time. Passive investment management refers to a portfolio management strategy that seeks to match the composition, and therefore the performance, of a selected market index. A recent study by Fulcrum Financial showed that over a 10-year time period, actively managed mutual funds underperformed their benchmark indexes about 75 percent of the time. Another study by Morningstar concluded that of 1,446 funds with the same manager for three years, only 22 beat the S&P500 index in 2002, 2003, and 2004.

Underperformance is mainly caused by expenses charged. Passive management is relatively low in cost as compared to active management. For an active large cap portfolio, a manager can generally expect to be paid better than 50 basis points, or 0.50 percent; for a passive portfolio, a manager could expect only about a quarter of that amount in fees. As an example, the large cap investment managers selected by both advisors demonstrated their inability to pick securities that would, net of fees, produce results higher than the benchmark. Exhibit 3.2 illustrates large cap manager results as of year-end 2003.

Higher fees provide managers with an incentive to recommend active investments over passive investments within the portfolio. Thus the advisors have a conflict of interest in recommending passive investments, as they would generate much lower fees. OHA should not rely on the advisors to recommend or analyze passive investing within the trust. This evaluation should be performed by OHA independent of the advisors.

**Exhibit 3.2
Large Cap Manager Results
December 31, 2003**

Investment (Index)	Year-to-Date 2003 Return	Benchmark Index Return	Relative Performance
GS Large Cap Growth (Russell 1000 Growth Index)	8.93	10.41	-1.48
GS Large Cap (Russell 1000 Value Index)	13.25	14.19	-0.94
FRIC Equity I Fund (Russell 1000 Index)	12.04	12.26	-0.22
FRIC Equity Q Fund (Russell 1000 Index)	11.80	12.26	-0.46

Source: Frank Russell and Goldman Sachs 2003 Year-End Performance Reports

OHA may have concluded that it does not accept current wisdom with respect to passive investing for any asset class. However, to fulfill its fiduciary duties to the trust and to achieve prudent investor standards, OHA must formally evaluate whether passive investments and their historical returns on investments would be appropriate trust fund investments.

***Ceded land payments
are not properly
considered***

One of OHA's largest sources of revenue is payment of ceded land revenues from the State of Hawai'i. Ceded lands are not directly held or owned by OHA. Rather, OHA, on behalf of native Hawaiian beneficiaries, is the recipient of certain revenue generated by such real estate. Ceded land revenue payments are a source of great uncertainty for OHA due to unresolved litigation and questions regarding their calculation and permanency. Based upon OHA's audited financial statements for FY2002-03, ceded land revenue payments were greater than the earnings from the trust fund. The ceded land revenue payments' relative size in terms of OHA's overall budget and the current earnings from the trust fund make it necessary to consider these payments in any investment decisions. For purposes of asset allocation, such a revenue stream should be included in any calculation. A reasonable estimate of the investment impact of these payments should be made.

With such information, asset allocation would need to take into account the unchangeable exposure to real estate represented by the ceded land revenue stream. Using only the ceded land revenue payments, OHA has an implied exposure to real estate easily exceeding the current allocated maximum of 15 percent set by the investment policy statement. This implied exposure does not begin to take into account the additional

exposure added by the advisors. Given such exposure, the current allocation to additional real estate investments may not be prudent. The current implied exposure to real estate should be considered in the asset allocation and investment policy statement.

OHA pays high management fees for some of its investments

We reviewed the trust fund's "Total Fund Performance Report" for the period ending December 31, 2003, as prepared by OHA's staff. This report includes a section entitled "Management Fees," which reconciles the fees paid as well as fees accrued for each advisor by asset class. Frank Russell averaged 57 basis points in fees, in total, for all traditional assets managed, excluding real estate, or 0.57 percent of the assets it managed. Goldman Sachs averaged 74 basis points, or 0.74 percent of the assets it managed, excluding real estate and hedge funds. The weighted average fee for investment management and oversight for the trust fund was 65 basis points, or 0.65 percent.

Using the 2002 Greenwich Market Dynamics report, an independently prepared industry report developed for comparing results of asset pools and funds, the average investment management fee paid by all reporting funds (1,032 reporting funds in 2002) was 27.4 basis points (0.274 percent) in 2002. Public investment funds tended to have higher fees, with an average of 27.8 basis points (0.278 percent) in 2002. Smaller funds (the trust fund would be included in this category) paid higher fees than larger funds; public investment funds with assets below \$500 million had average fees of 35.1 basis points (0.351 percent).

It should be noted the fund averages in the Greenwich report include passively managed assets, which have materially lower fee structures that would reduce the mean for those plans. The fully active strategy employed by OHA has led to materially higher fees than fees incurred by its peers. In addition, OHA's use of investment advisors to select investment managers, perform due diligence, and monitor the investment managers, has the effect of increasing the total fee, since the total fee represents more than just investment management fees.

If OHA's passive assets were in line with its peer median, fees would be reduced by 11 basis points, saving the agency more than \$300,000 annually. This situation assumes that passive investments would replace a portion of the large cap portfolio and that each investment advisor would have the same proportion of its oversight reduced.

OHA has already begun to review the investment management fees being paid, realizing at the board level that Goldman Sachs represents a premium cost for its services. Goldman Sachs has responded with a discount of 10 percent of its separate overall advisory fee (a reduction from 30 to 27 basis points), which would bring its total average fees to 71 basis points.

OHA should continue to evaluate the returns it receives, net of the fees paid, and explore alternative means of investing portions of its portfolio. It should also recognize the inherent conflict of interest within the existing manager-of-managers structure and conduct its own evaluation of whether active or passive investments fulfill its fiduciary duties and achieve prudent investor standards.

OHA does not have a procedures manual for investments

As part of the review process, we requested from OHA, but did not receive, a copy of its current procedures manual for investment oversight and controls. OHA has failed to create a procedures manual to document all aspects of internal policies and procedures related to investment activities, transactions, reconciliation, reporting, and control. Since such a manual does not exist, we cannot provide any feedback or recommendations on current procedures within OHA.

A procedures manual outlines those functions required of an organization's operations. Such a manual represents a record of the controls in place for OHA's operations. It provides assurance of the completeness of actions and activities dealing with the operation and examples of procedures for use in training, succession planning, and personnel turnover. It documents the fiduciary duty to provide adequate guidance and oversight to staff and provides a safeguard in times of disaster and disaster recovery.

We requested that OHA staff draft a summary document to outline those investment management and oversight actions that are being performed in the absence of a procedures manual. We received documentation that provided information related to reconciliation, ledger reporting, and basic performance reporting. These items appear consistent with those functions understood to be performed by staff, based upon interviews with OHA staff, administration, the advisors, and individual trustees. Based on this information and our interviews, we believe these basic procedures and processes are being performed. However, the failure by the Board of Trustees to ensure a procedures manual exists, as well as the administration's failure to address this deficiency, points to a shortcoming in oversight and expertise related to one of the most material functions of OHA: the safeguarding of assets placed in its trust.

OHA's Lack of Advisor Oversight Prevents the Board of Trustees from Receiving Sufficient Information to Evaluate the Investment Advisors' Performance

OHA decided in 2002 to move from direct selection and oversight of investment managers to investment advisor selection, monitoring, and termination of investment managers. This platform requires the investment advisors to perform many of the duties previously performed by the Board of Trustees and OHA staff. OHA was required to take on the new duty of management and oversight of the investment advisors. This new duty is in many ways similar to the review of investment managers that OHA had previously performed. However, OHA has not adequately overseen the advisors and has failed to create an internal function that provides sufficient oversight of the investment advisors and prepares complete and independent reporting. It has allowed the advisors to develop their own reporting formats, which are incomplete and inconsistent between them, and has not physically visited and inspected the advisors' facilities. The internally prepared reporting is inadequate to evaluate the two advisors' activities and performance and does not provide for an evaluation of their actions. In addition, the investment policy statement requires certain actions by the investment advisors that OHA is unable to verify.

OHA has failed to create an independent function to oversee investment advisors

Best practices in the area of institutional investment management generally conform to a concept of front office functions, middle office functions, and back office functions. Front office functions include policy decisions, asset allocation, and manager selection. Middle office functions include preparing performance and other reports, overseeing controls, interacting with investment advisors, and preparing general ledger reports. Back office functions include those duties performed by the custodian and record keeper, such as buying and selling securities, handling cash funds, safeguarding assets, and preparing transaction-related reports.

We found that there is adequate support for both front office functions and back office functions; however, many middle office functions are not being performed. Many of these functions have by default been performed by the advisors, with OHA retaining only general ledger duties. The advisors have middle office responsibilities associated with their investment manager oversight, such as performance reporting, ensuring compliance with guidelines, and risk management. Nonetheless, OHA must also perform these activities, independent of the advisors, with respect to its selection and monitoring of the advisors and reporting on and evaluating the trust as a whole.

OHA's failure to perform middle office functions is due, in part, to a lack of expertise regarding investment oversight and best practices. OHA has not retained personnel or independent consultants with

experience in institutional investment oversight. Without access to the knowledge and experience necessary to perform the required oversight and reporting duties, these functions will not be performed.

Neither OHA staff nor the Board of Trustees independently prepares an analysis of the advisors' actions

The Board of Trustees, in its list of action items dated January 16, 2003, acknowledged that the transition from separate money managers to a manager-of-managers approach (i.e., use of the two investment advisors) did not relieve the board of its fiduciary obligations and that it would still be required to “monitor . . . the Investment Advisor to ensure they [sic] act prudently and follow the Investment Policy guidelines.” Currently, this monitoring process includes a summary report to the board prepared by OHA staff that presents information provided by the advisors. It includes asset class rates of returns and invested totals, as well as a summary of investment management fees. While this information is useful and the components of this report are absolutely necessary, the level of reporting and detail and the independence of the source are not adequate. The current process requires the advisors to report their own results and present to OHA and the board what they believe is relevant.

OHA should instruct the advisors on the content of the report to ensure accuracy and independence in the report's creation. The advisors should prepare and provide detailed information on the underlying investment managers, as specified by OHA. OHA should prepare, or have prepared by an independent source, reports that evaluate the impact of investment manager selection and allocations made by the advisors. The report should detail the relative risk of the portfolio and the consistency of the investment style. OHA should also have information on the total portfolio, including characteristics such as the exposure to different economic sectors, the market capitalization of the portfolio, country exposures, dividend yields, and many other key indicators of a portfolio's performance. This information is needed by OHA to evaluate the advisors' job performance. It is not prudent for the advisors to prepare their own evaluation because of an inherent conflict of interest in such a process.

OHA has not performed adequate due diligence and monitoring of the advisors

OHA and the Board of Trustees requested detailed information from each candidate for the investment advisor position as part of the selection process. The information included details of each candidate's personnel, processes, and procedures in searching for investment managers, selecting those managers, and performing on-going monitoring. OHA asked questions regarding adherence to regulatory compliance procedures, segregation of duties, independent custodians, and other key duties of an investment advisor. Candidates responded to OHA in documents and in interviews conducted by the Board of Trustees. All of these actions are prudent and would be expected of a fiduciary as part of

a delegation process. However, the process does not stop there. OHA has not visited the physical sites of the advisors or formally evaluated advisors' manager selection process, manager monitoring, compliance activities, pricing methods, or other advisor duties.

OHA has a duty to visit the physical location of each advisor and to review each of their operations, personnel, processes, and procedures, both as part of the initial due diligence and as part of the ongoing monitoring of the advisors. Just as if the function were to be performed by OHA staff within its own facilities, there is a duty to fully understand and document the processes and procedures performed by the advisors. No visit has been made to Frank Russell's facilities, and only a single visit by one trustee to Goldman Sachs' offices has taken place, though not in the context of on-site due diligence and monitoring.

OHA's lack of a standard report format has resulted in inconsistent reporting by the advisors

At the current time, each advisor has materially different report formats. While both prepare summaries of their performance, each uses different benchmarks and prepares reports on a different basis, with one netting all fees and the other netting only certain fees. This inconsistency requires OHA to adjust the reports to make them comparable. The impacts of manager selection and asset allocation are not clearly presented, and the level of detail in the report differs materially.

Certain essential information is not presented. Information on the risk taken by the advisors, or the risk's impact on the results of the portfolio, is not included in the current reports. Universe rankings, defined as how well the advisor has performed compared to the universe of investment advisors for investment pools similar in size and nature as the trust fund, are also missing, though required by the investment policy statement. Descriptions of the characteristics of the investments by each advisor also are not comparable. This lack of completeness and comparability makes it difficult to evaluate each advisor's performance and to compare their actions and results.

OHA has failed to create a standard format for reporting information to be used in evaluating investment advisor performance. It does not know what information it needs on a recurring basis to efficiently evaluate the advisors' actions and results. This failure has occurred because OHA does not have the expertise to know what should be included in the reports. Instead, OHA has relied on the advisors to determine reporting requirements, a process that is fundamentally flawed. Reliance on the advisors fails to consider the inherent conflict of interest. Advisors may be reluctant to provide the detail that may reveal poor performance. Thus, determining the nature and content of reports should not be left to

the advisors. If necessary, OHA should consider utilizing external consultants with expertise in designing the reporting format for investment advisor performance evaluation.

Current reports on the trust fund are insufficient

The current level of trust reporting is not adequate to evaluate the impact of decisions made by the Board of Trustees with regard to trust fund investments. The level of reporting provided by OHA staff must be improved to allow for the timely evaluation of decisions and to provide complete and accurate feedback that may lead towards process improvements and refinement. The same level of information should also be reviewed by the board for the trust fund as a whole. The current reporting for the trust fund includes a report of total asset value; the total asset allocation of the trust fund and the allocations made by each investment advisor; total performance, adjusted for fees; a written discussion of each asset class; and a summary of fees. Trust level attribution, risk, peer and universe comparisons, benchmark discussions, style, and total trust fund characteristics are not presented.

Investment advisor compliance with certain guidelines cannot be verified

In its investment policy statement, OHA has adopted guidelines for each asset class. These guidelines specify the requirement for best execution in trading, certain performance objectives, portfolio characteristics, minimum number of securities, allowable investments, and other restrictions. The guidelines require the immediate correction of any violation and reimbursement to the trust fund for any resultant losses incurred. Both advisors have signed each asset class guideline, indicating acceptance of the guidelines.

Restrictions on types of securities and on account characteristics reflect the amount and type of risk that OHA is willing to undertake. OHA's guidelines, although more detailed than many sets of guidelines we have reviewed, are reasonable. Our review of the guidelines finds adherence to them should be in the best interest of the trust fund, given the level of risk OHA is willing to undertake. However, given the manager-of-managers structure, OHA currently has very little ability to ensure compliance with the guidelines. OHA is not receiving sufficient information from the advisors and does not have software to screen appropriate information to ensure compliance with the guidelines. The advisors are not currently required to sign on a recurring basis a disclosure statement that would demonstrate compliance with the investment guidelines. Since the advisors are liable for any losses due to their failure to comply, it is not in their best interest to report such violations to OHA.

Knowing this, OHA should require that both advisors attest in writing to their compliance with the investment guidelines. Further, OHA should design standard formats for and receive regular compliance reports created by the advisors related specifically to the investment managers retained for the trust fund.

OHA has not created a standard set of contracts for the retention of investment advisors

OHA entered into contracts with Frank Russell Trust Company in February 2003, (Contract 1596) and with Goldman Sachs Asset Management Company in March 2003 (Contract 1595) to perform discretionary investment management and to provide investment advisory services to OHA related to assets held within the trust fund. The Goldman Sachs contract was amended in July 2003 to update the reference to the newly revised investment policy statement. The Frank Russell contract was terminated in July 2003, with the execution of a trust agreement between OHA and the Frank Russell Trust Company.

OHA negotiated separately with each advisor. In each case, the standard contracts of the respective advisors were used as the basis for the final contracts. As a result, the two contracts are quite different with several materially different provisions, including the following:

1. The Goldman Sachs contract specifically incorporates the investment guidelines included in OHA's investment policy statement, limiting the advisor to those securities specified. The Frank Russell agreement does not refer to the guidelines and specifically allows for the acquisition of assets precluded by the investment policy statement.
2. Liability and indemnification clauses are quite different.
3. The Frank Russell agreement is silent with regard to certain performance reporting requirements included in the investment policy statement.
4. Hawai'i law governs the Frank Russell agreement while New York law governs the Goldman Sachs contract.

The differences in the contracts and the fact that each advisor's standard contract provided the basis for the final agreements caused confusion for many of the trustees. Uncertainty over OHA's liability under each agreement and the process by which the agreements were approved spurred the trustees to request additional legal reviews. Reviews by both OHA staff attorneys and outside counsel to the Board of Trustees revealed that OHA does not have specific policies and procedures pertaining to contract format. A review and approval process of advisors also does not exist.

The lack of a common template for contracts or policies regarding review and approval of advisors led to different agreements with different terms. This disparity can create inefficiency in the administration of the contracts and can lead to contracts that do not contain all terms desired by OHA. Best practices in the industry currently support standardized contracts with those changes that are mandated by a particular service provider to be included in an attachment or side letter and made part of the contract by reference. Standardized contracts would also eliminate the inefficiencies surrounding multi-vendor relationships and ensure changes in the program can be implemented among all service providers in the same manner. It would also prevent key fiduciaries from misunderstanding contract terms covering the management of trust fund investments.

The process for including alternative asset investing could be improved

The most recent asset allocation study identified absolute return investments, generally described as hedge funds, as an asset class to be included within the trust fund. These investments are generally unregulated offerings. They are characterized by both long (purchasing a stock for resale at an anticipated higher price at some later date) and short positions (borrowing stock from another investor, selling it today to reap profit and replacing the stock at some later date when the stock price has moved lower), trading in a wide variety of financial securities and instruments, and often using borrowings to increase the level of returns. Due to their complexity, hedge funds are highly dependent on the investment manager for desirable results, making manager selection very important and diversification of manager exposure a key objective.

Alternative, or hedge fund, investing is also relatively expensive. Most managers have a two-part fee structure, receiving both a management fee, usually 1 percent of the assets under management, and a performance-based fee or incentive, which is typically 20 percent of the net profit of the account. For example, if a fund were up 10 percent, the manager would receive 1 percent in management fee plus 1.8 percent in performance fee for a total fee of 2.8 percent. Since investors want to diversify by manager and strategy, many firms offer a fund-of-funds approach, whereby an investor invests in a top-level fund and the manager of that fund investigates and retains underlying funds. This approach also adds a layer of fees, as the underlying managers receive their 1 percent and 20 percent profit, and the top-level manager also receives a management fee and potentially a performance fee.

The advisors have only recommended those alternative asset investments within their offerings. We generally agree with an exposure to this asset class. In addition, given the level of expertise within OHA and the relative size of the investments, we believe a fund-of-funds approach is a reasonable means to enter this asset class. However, reviewing only the

offerings of the two advisors severely limits the investing potential. There are more than 6,000 hedge funds, and more than 1,000 fund-of-funds, from which the office can choose. It is possible a fund with better returns, characteristics, terms, or costs may be available. The advisors, however, are not compensated to present other solutions. They are best compensated by their proprietary offerings. Reviewing only hedge fund offerings of the advisors severely limits the investable universe. More solutions could be made available to OHA by combining the moneys assigned to this asset class, rather than splitting the moneys between the two advisors.

Finally, many fiduciaries retain specialized advisors for alternative investments due to the complexity of the industry and the need for independence. We would recommend OHA document its reasoning to source all advisor duties to the advisors, given the potential conflict of interest. OHA may be better served by segregating the alternative asset exposure and retaining separate advisors for that part of the portfolio.

OHA has not evaluated the use of trust assets within the context of its obligation to aid native Hawaiians

In adopting the current investment policy statement and its asset allocation, OHA has made a decision to include investments in real estate and private equity. While we question the real estate exposure, the addition of private equity is reasonable. Private equity refers to investing in non-publicly traded forms of debt or equity, or both. It usually relates to entities that may have been created as a start-up organization, a spin-off of a subsidiary, or a public company being taken private through a management buy-out. This asset class has characteristics that differ from publicly offered securities, which aids in diversification. Since private equity funds are direct investments in businesses, this type of funding can have a key impact on a particular organization's success or failure.

OHA, through its investment advisors, decided to take a fund approach; that is, investing in a fund that would in turn identify investment opportunities directly in companies or in other funds that would make direct investments. This approach is traditional for institutional funds, due to the extremely steep learning curve required with this type of investment and the costs associated with making and overseeing direct investments.

Given OHA's mandate to improve the lives of native Hawaiians, we think it prudent for OHA to explore the possibility of using some private equity investing to support businesses and owners that meet both the investment criteria of the portfolio as well as OHA's mandate. Such investment opportunities may not exist, or a process of identifying such opportunities may not be cost effective. However, we think OHA should have that understanding now, rather than be questioned in the future without having explored the potential. Should it be decided that real

estate continues to be a prudent investment of the trust fund, a similar argument could be made to own real estate that both benefits native Hawaiians and provides an attractive risk/return opportunity for the trust fund. OHA should fully explore the possibility of cost effectively undertaking that type of investing as well.

Conclusion

The processes implemented and actions taken by the Board of Trustees have helped to improve the direct investment oversight of the underlying investment managers and the returns of the trust fund. The development of the investment policy statement, asset allocation study, spending policy study, and manager-of-managers structure have all contributed to these improvements. OHA now needs to better implement oversight of the new process, recognizing the inherent conflicts of interest within the new structure and taking steps to improve reporting, better define its oversight duties, and limit the impact of potentially conflicted advice.

Recommendations

The Office of Hawaiian Affairs should:

- a. Revise components of its investment policy statement as follows:
 - i. Delineate the legislative and procedural authority of OHA and the Board of Trustees to make and refine investment policy;
 - ii. More clearly define the benchmarks to be used by the investment advisors, ensuring accuracy and consistency;
 - iii. Set performance objectives and means of measurement for the trust fund as a whole, consistent with those applicable to each investment advisor;
 - iv. Evaluate the use of passive investments with those asset classes in the portfolio where it is practical and supported on a net of fee basis; and
 - v. Formally review the impact of ceded land revenue payments from the State of Hawai'i in terms of asset allocation and the need for additional real estate investments;
- b. Create a procedures manual, outlining the processes, controls, reporting requirements, and oversight of the investment process;
- c. Improve its oversight of the advisors. The improvements should include:

- i. Creating an independent function, either within or in conjunction with an external consultant, to aid in reporting and oversight;
 - ii. Improving the formal analysis and reporting associated with the activities and performance of the advisors;
 - iii. Creating a schedule and review process that includes visits to both investment advisors' place of business and more completely analyzes their processes and controls;
 - iv. Designing a consistent reporting package to be received from each investment advisor, containing a complete analysis of actions;
 - v. Improving reports on the trust fund as a whole;
 - vi. Developing processes to ensure that the advisors comply with investment guidelines included in the investment policy statement; and
 - vii. Standardizing the contracting process and contracts used to retain investment-related service providers;
- d. Improve the alternative asset investing process by considering the aggregation of funds to be invested in this asset class and the possible retention of a separate and independent advisor; and
 - e. Formally evaluate the use of trust fund assets to meet the organization's duty to better the lives of native Hawaiians.

Appendix A Ten Major Goals of OHA's Strategic Plan 2002-2007

Goal 1	Advocacy--Native Rights	By 2007 OHA shall have devised and implemented strategies to protect Native Hawaiian rights and entitlements and secured at least one significant legal outcome; created a legal mechanism to assure a predictable on-going revenue stream from the Public Land Trust; and ensured the settlement of the blood quantum issue.
Goal 2	Culture	By 2004 OHA shall have drafted a plan that identifies and provides solutions to safeguard endangered traditions, practices and rights, and subsequently put into practice steps that will protect, re-establish and enhance Hawaiian cultural assets by the year 2007.
Goal 3	Economic Development	By 2007 OHA's investment in the creation and retention of wealth for Native Hawaiians shall have: 1) impacted at least 7 percent of the total statewide Native Hawaiian population by improving economic solvency and 2) accounted for a return on investment to OHA "equal or greater than the cost of capital used to fund the activity and/or OHA's current rate of return (total fund) from the Native Hawaiian Trust Fund."
Goal 4	Education	By 2007 OHA shall have assisted 28,750 Native Hawaiians to achieve age appropriate literacy.
Goal 5	Environment--Natural Resources	By 2007 OHA shall have protected natural and cultural resources through the adoption of stewardship standards by five public and ten private entities as evidenced by research, studies and partnerships; and the enactment of new laws, ordinances and rules.
Goal 6	Nationhood	By 2007 OHA shall have assisted, coordinated and enable the creation of a unified Hawaiian Nation.
Goal 7	Administration	By 2007 OHA shall have initiated, collaborated, partnered and advocated with other agencies and organizations through five Memorandum of Agreements that will commit the signatories to act assertively together on behalf of their beneficiaries-in-common.
Goal 8	Social Services	By 2007 OHA shall have improved the quality of life for 17,500 Native Hawaiians in the areas of food, shelter, and safety.
Goal 9	Land and Housing	By 2003 OHA shall have increased the percentage of its investment in real estate by no less than 15 percent and shall develop strategies to enhance the use of these assets to benefit the Native Hawaiian people.
Goal 10	Health	By 2007 OHA shall have collaborated with other Native Hawaiian health care providers to increase the acquisition of resources from federal, state, counties and others, to address the health care needs of Native Hawaiians with particular focus on the needs of the aged and elderly, including but not limited to prevention, treatment, education, and other needs.

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Response of the Affected Agency

Comments on Agency Response

On March 21, 2005, we transmitted copies of a draft of this report to the Board of Trustees of the Office of Hawaiian Affairs (OHA). A copy of the transmittal letter is included as Attachment 1. The board's response includes a document entitled *2005 Master Plan* with a hand-written annotation, "Draft #1 (March 2005)." The response, without the enclosed document, is included as Attachment 2.

In its response, the Board of Trustees does not disagree with our recommendations or the recommendations of our consultant KPMG LLP. The trustees acknowledge that portions of the report will aid in improving OHA's services, but "question the substance and wording of much of [the] report." In particular, the board questioned our findings on OHA's lack of a comprehensive master plan, unsubstantiated and questionable expenditures, and rates of delinquency and default on loans under the Native Hawaiian Revolving Loan Fund. We nonetheless are not dissuaded from our findings and stand by the substance and wording of our report. We highlight certain matters below.

The board disagrees with our finding that a comprehensive master plan is still lacking. It asserts it has developed such a plan and recounts an institutional history of its master plan development, beginning with a 1982 document. In *OHA's Strategic Plan 2002-2007*, however, the agency itself recognizes that "OHA's Master plan [i.e., the 1982 document as revised,] was not this comprehensive master plan," and expresses a hope that its strategic plan, synthesized with the strategic plans of other agencies, would serve as an impetus for a renewed effort toward a comprehensive master plan in FY2002-03. The renewed effort apparently did not occur within that timetable. Moreover, the draft document, dated March 2005 and submitted to us with the board's response, still does not appear to be that comprehensive master plan. It is essentially OHA's own strategic plan, compiled with other OHA documents. And, unlike the product OHA had hoped for, it is not a synthesis of various agencies' strategic plans for Hawaiians and native Hawaiians.

The board also questions our finding regarding \$800 in petty cash payments made without receipts or any other documentation to support the expenditures. It claims that our office did not ask for supporting documentation for these expenditures. Contrary to OHA's assertions, our office, in a follow-up communication with OHA staff, did request additional information, such as receipts or other documentation, to

support these particular petty cash disbursements. OHA's responses generally offered to make available documentation approving the expenditure requests. Request and approval forms, however, for petty cash expenditures do not amount to documentation that substantiates the actual amount spent, and do not meet OHA's own requirement in its *Administrative and Financial Manual of Guides* at Title 4, Chapter 2 ("Petty Cash"), Section 4-2-7, that "each petty cash voucher must in turn be supported by the related cash receipt, cash register tape, invoice, freight bill, or other original documentary evidence of disbursement."

The board also disputes the significance we attach to "relatively minor expenditures" for such items as internal office events and a microwave oven for the staff. OHA has been entrusted with a high purpose: the betterment of the conditions of all Hawaiians. The State's expectation is that this trust will be met with the highest fiduciary watchfulness—with unambiguous fiscal controls, proper accounting and accountability, and an unwavering institutional intolerance for abuse, regardless of expenditure amounts involved. We found that OHA fell short of that expectation. Although we do not disagree that morale-boosting events for staff are worthy undertakings, we do take issue with the funding of such events with moneys, however small the sum, placed under the fiduciary care of OHA for its beneficiaries. These office events are the initiatives of OHA officials as managers of its employees and are essentially for the direct benefit of OHA's staff, not its beneficiaries.

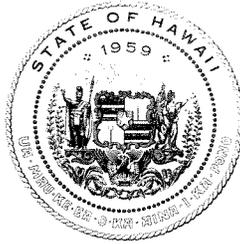
The board also asserts that our finding of "deep-rooted problems" in the administration of the Native Hawaiian Revolving Loan Fund (NHLRF) is unsupportable. Critical of our computation of a combined delinquency and default rate, the board claims the rate should not include loans in default (that is, non-performing loans) to comport with industry practice and with the recommended formula of the federal Administration for Native Americans (ANA). According to the board, the rate should not include loans to be charged off.

We disagree on several counts. An ANA representative clarified with us that loan status can be reported on several levels, depending on the number of days a borrower may be behind in loan payments. In OHA's case, although it intends to charge off its non-performing loans (that is, loans in default), the amounts involved were still on its books as of January 31, 2004, and were included as part of total NHLRF outstanding loans in its monthly delinquency report. For loan management purposes, loans with payments over 30 days late are distinguished from those that are non-performing, and a separate rate may be calculated for each category in relation to total loans outstanding (and in fact, ANA does these separate calculations). Loan administrators are apt to deal differently with borrowers in each category.

A combined rate, however, is neither inappropriate nor incorrect to depict the revolving fund's health as a whole—a practice we have also seen in forms filed with the U.S. Securities and Exchange Commission. Our report focuses on the impact of OHA's actions on all of its beneficiaries. OHA's duty with respect to the NHLRF is to all of its beneficiaries—whether demonstrated in terms of careful oversight of current borrowers or diligent preservation of the revolving fund's availability to other beneficiaries as potential borrowers. In any case, a delinquency rate of 14.9 percent, as calculated by OHA, is still a concern. The ANA notes that in the "industry" an acceptable delinquency rate for loan accounts ranges between 3.5 to 5 percent; OHA's delinquency rate of nearly 15 percent triples the industry norm. OHA's delinquency rate, standing alone, is also misleading in terms of presenting a complete picture of revolving funds available (or not available) to all of its beneficiaries.

Our final report contains a few minor editorial changes for purposes of accuracy and style.

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917



MARION M. HIGA
State Auditor
(808) 587-0800
FAX: (808) 587-0830

March 21, 2005

COPY

The Honorable Haunani Apoliona, Chair
Board of Trustees
Office of Hawaiian Affairs
711 Kapiolani Boulevard, Suite 1250
Honolulu, Hawaii 96813

Dear Chair Apoliona:

Enclosed for your information are three copies, numbered 6 to 8 of our confidential draft report, *Audit of the Office of Hawaiian Affairs*. We ask that you telephone us by Wednesday, March 23, 2005, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Wednesday, March 30, 2005.

The Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

A handwritten signature in cursive script, appearing to read 'Marion M. Higa'.

Marion M. Higa
State Auditor

Enclosures



ATTACHMENT 2

STATE OF HAWAII
OFFICE OF HAWAIIAN AFFAIRS
 711 KAPI'OLANI BOULEVARD, SUITE 500
 HONOLULU, HAWAII 96813

April 8, 2005

RECEIVED

Ms. Marion M. Higa
 State Auditor
 Office of the Auditor
 465 S. King Street, Room 500
 Honolulu, Hawaii 96813-2917

2005 APR -8 PM 3:40

OFC. OF THE AUDITOR
STATE OF HAWAII

Aloha Ms. Higa:

‘O ka leo aloha kēia iā ‘oe e Marion Higa me ke ke‘ena moku‘āina e noho loiloi ana ma luna o mākou ke Ke‘ena Kuleana Hawai‘i nona ke kuleana ‘o ka paipai lāhui ‘ōiwi Hawai‘i. Mahalo kou mana‘o e ho‘omaika‘i mai iā mākou a me nā mana‘o e paka a ho‘oponopono mai kekahi. Ua heluhelu ‘ia kou hō‘ike kāmua me ka maka‘ala loa a eia iho nō kā mākou leo panena. Ma muli ho‘i o ke ko‘iko‘i o kā mākou kuleana no ka ‘ōiwi a‘o kona kulāiwi ‘o Hawai‘i Pae‘āina, ua ana pono ‘ia nā mana‘o o mākou me ka mana‘olana, he maika‘i ana nou kekahi. No laila, aloha kākou a pau loa.

Mahalo for the praise of OHA’s efforts and the suggestions for improvement contained in your preliminary draft *Audit of the Office of Hawaiian Affairs*. We are especially pleased at your statements that “OHA is commended for developing a strategic plan” (page 15 of your draft) and that “[t]he processes implemented and actions taken by the Board of Trustees have helped to improve the direct investment oversight of the underlying investment managers and the returns of the trust fund” (page 43).

As we understand it, the central message of your report is that we’ve come a long way but we still have far to go. That’s a message that any individual or organization should welcome.

However, we do question the substance and wording of much of your report. For example, by hinting that a breach of fiduciary duty occurred, you mislead your readers since such a conclusion is not justified by the information and arguments that you present. Another example: you incorrectly describe OHA as acting like a fledgling agency, despite our rich history of beneficiary service and despite our improved management operations. Having said that, on balance we believe that certain areas of your report will help us to improve our services to our native Hawaiian and Hawaiian beneficiaries.

We, therefore, accept your invitation to comment on your comments and recommendations, as follows:

FROM CHAPTER 2 OF YOUR REPORT

Recommendation # 1:

The Board of Trustees of the Office of Hawaiian Affairs should resurrect efforts to develop a comprehensive master plan and provide administrative support for this effort.

Our Response:

The heading on page 12 (“The Board of Trustees still has not provided a comprehensive master plan”) and the wording in the first paragraph on page 12 (“to date ... a comprehensive master plan remains elusive”) imply that OHA has never completed a master plan. This is incorrect. OHA created a Master Plan in 1982, and it clearly references compliance with Section 10-6, Hawai‘i Revised Statutes. That plan was updated in 1986 and 1988 and was referred to in 1991. The needs assessment portion was updated in 1994.

We acknowledge the statutory requirement to continually update the master plan. We have shown compliance with that provision through the various revisions to the 1982 Master Plan. Where we may have fallen short is publication of the revisions along the way and during the audit period. However, we want to emphasize that updated elements of the Master Plan have been in practice at OHA, and *OHA’s Strategic Plan 2002-2007* is in fact the end result of the various updates prior to 2001.

Section 10-6, HRS requires OHA’s master plan to include:

- (A) Compilation of basic demographic data
- (B) Identification of the physical, sociological, psychological, and economic needs of Hawaiians
- (C) Establishment of goals pursuant to programs and services for Hawaiians
- (D) Establishment of priorities for program implementation; and
- (E) Organization of administrative and program structure.

In response to requirement (A), OHA first compiled basic demographic data on Hawaiians in the *Population Survey/Needs Assessment Final Report* issued in 1986. In 1988, OHA published complete demographic information in a separate book of appendices that accompanied the 1988 revision of the OHA Master Plan. In 1992, OHA funded publication of the *Native Hawaiian Health Data Book* by Papa Ola Lōkahi. In 1994, OHA published its first *Native Hawaiian Data Book*, which has extensive data on the health, education, income, employment, housing, and human service needs of Hawaiians. The *Native Hawaiian Data Book* was updated and published again in 1996, 1998, and 2002. The 2005 edition is completed and scheduled for printing in July of this year and is the most comprehensive publication to date.

In addition, OHA uses data compiled by Kamehameha Schools from the 2000 U.S. Census. This data includes *Hawaiians in the USA: US Census 2000* (a map) and *Aloha Counts: Census 2000 Special Tabulations for Native Hawaiians* (a statistical summary). In the area of health, OHA commissioned rider questions onto the Department of Health's survey in 2001 and contracted a housing needs assessment in 2002.

In response to requirement (B), OHA's staff in the Beneficiary Advocacy & Empowerment area regularly identify the physical, sociological, psychological, and economic needs of Hawaiians as they seek to address those needs through funding and program assessments.

For example, the physical needs of Hawaiians are identified and addressed by:

1. Health staff, who fund and/or partner with health programs to provide basic medical care, medical insurance, health screening, drug coverage, dental care, dialysis, and preventive care.
2. Housing staff, who fund and/or partner with programs to provide housing in all forms, from emergency housing to home counseling and home ownership. In partnership with the DHHL, OHA provides "gap" funding for home purchase financing.
3. Human Services staff, who fund and/or partner with programs to provide emergency funds and counseling for needs such as rent, rental deposits, funerals, work tools, and car repairs.
4. Native Rights staff, who advocate on behalf of Hawaiians on land and water issues so they can have land and water on which to live and farm. In this regard, OHA funds the major portion of the Native Hawaiian Legal Corporation's operating budget.

The sociological needs of Hawaiians are identified and addressed by:

1. Education staff, who fund and/or partner with programs to provide K-12 students with opportunities to learn in a culturally appropriate manner and provide scholarships for Hawaiians to attend college.
2. Native Rights staff, who advocate on behalf of Hawaiians for the protection of cultural sites and practices. OHA provides all of the funding for the Native Hawaiian Historical Preservation Advisory Council's work.
3. Human Services staff, who fund and/or partner with programs to provide emergency funding and counseling.
4. Hawaiian Governance staff, who advocate for the creation of a Native Hawaiian governing entity so Hawaiians can have autonomy in allocating resources and deciding how best to address their needs.

The psychological needs of Hawaiians are identified and addressed by:

1. Health staff and Human Services staff, who fund and/or partner with programs to improve the psychological well-being of Hawaiians either through counseling or hands-on, work therapy

2. Hawaiian Governance staff, who advocate for the creation of a Native Hawaiian governing entity so Hawaiians can heal from the overthrow in 1893 and direct their future through self-determination. In collaboration with the Hawaiian Civic Clubs and Hawaiian Societies, a working coalition to address the sovereignty issues is funded by OHA.

The economic needs of Hawaiians are identified and addressed by:

1. Economic Development staff, who provide personal loans and business loans to improve economic status. In collaboration with the Administration for Native Americans (ANA), the Native Hawaiian Revolving Loan Fund provides low interest business loans to Hawaiians starting businesses.

2. Education staff, who provide scholarships and information on educational programs so Hawaiians can graduate from high school, receive vocational training, and receive college degrees, including graduate and professional degrees.

3. Support, through funding, the mission of Alu Like in job training, creation of jobs and economic opportunities for Hawaiian youth and adults while remaining loyal to Hawaiian values and practices.

In response to requirement (C), OHA has already established goals pursuant to programs and services for Hawaiians. This was done by way of *OHA's Strategic Plan 2002-2007*, which the Auditor addresses on page 14. Discussions for the strategic plan were started in 2001. The plan was implemented beginning in fiscal year 2002-03 and is now in its third year. On page 15, the Auditor commends OHA for developing a strategic plan. It was a long, arduous process that entailed numerous community meetings and discussions throughout Hawai'i. It is important to note that the Master Plan of 1982, along with its various revisions over the years, formed the basis of the current strategic plan.

Further, we respectfully disagree with the Auditor's assertion on page 15 that

OHA, and other government and private agencies, are making strategic decisions without a foundation of basic demographic data, basic beneficiary needs, and a shared understanding of immediate and long-range goals for the betterment of conditions of all Hawaiians.

As explained above, we regularly publish and update demographic data that provides Trustees and Administration substantial insight into the problems and needs of our beneficiaries. We constantly use that information to make strategic decisions, contrary to your statement. We routinely collaborate and partner with a wide variety of organizations, both government and private, to deliver the services outlined in item (B) above. These collaborations and partnerships

are based on a shared understanding of goals for the betterment of the conditions of Hawaiians. As a sampling, we list the following agencies and organizations with whom we have worked since the last audit to provide various services to Hawaiians.

Government Agencies

State of Hawai‘i:

- Department of Education
- Department of Hawaiian Home Lands
- Department of Health
- Department of Human Services
- Department of Land and Natural Resources
- Executive Office on Aging
- Governor’s Task Force on Hawaiian Children in Foster Care
- Maui Community College/Windward Community College/Kaua‘i Community College
- UH at Hilo, Ka Haka ‘Ula O Ke‘elikōlani College of Hawaiian Language
- UH at Mānoa, Kamakakūokalani Center for Hawaiian Studies

U.S. Government:

- Administration for Native Americans (ANA)
- Department of Agriculture
- Department of Housing and Urban Development

Private Organizations

- Alu Like, Inc.
- American Civil Liberties Union
- Association of Hawaiian Civic Clubs
- Bank of America
- Bank of Hawai‘i
- Bank of Seattle
- Bishop Museum
- E Ola Mau
- First Hawaiian Bank
- Habitat for Humanity
- Hawai‘i Technology Institute
- ‘Īlio‘ulaokalani Coalition
- Kamehameha Schools
- Ke Ola Mamo
- Lunalilo Home
- Nā Pua No‘eau

Native Hawaiian Education Association
Native Hawaiian Education Council
Native Hawaiian Legal Corporation
Papa Ola Lōkahi
Pacific Resources for Education and Learning (PREL), Inc.
Queen Lili‘uokalani Children’s Center
Queen's Health Systems
State Council of Hawaiian Homestead Associations
Wai‘anae Coast Community Mental Health Center
Other less recognized service providers to meet Hawaiians’ needs.

In response to requirement (D), OHA has, in fact, established priorities for program implementation. This has been done by way of work plans developed by *hale* directors and other managers. In the plan revisions of 1986, the management auditor strongly recommended “Divisional Plans” be made aside from the Master Plan. OHA followed that recommendation. That very process continued in 2004.

In response to requirement (E), we do, in fact, have an administrative and program structure that allows the organization to work more effectively. The 2003 reorganization the Auditor refers to on page 15 was initiated for that purpose. The organizational chart shows how personnel are aligned. The functional statements explain the function and role of each section and position. Facilities are managed by a particular section, the Office of Board Services.

For all of the reasons outlined above in response to requirements (A) through (E), we believe that implementation of a master plan is close at hand. Certainly, the essential ingredients of a good master plan have been assembled. We commit to finalizing an update to the master plan in the next several months. To that end, the above-described records have been compiled and are attached as Draft #1, *OHA Master Plan Update 2005*. Over the next several months, we will seek community input on this draft, finalize the updated plan, and distribute it to the public.

Please know we remain committed to a continual, comprehensive planning process which began in 1982 and as evidenced by the recent appointment of a full-time planner and creation of an Evaluations section to provide ongoing assessments of programs, both internal and external.

Recommendation #2.a:

The Office of Hawaiian Affairs should develop the appropriate management tools to guide implementation of its strategic plan, including but not limited to policies and procedures on action planning and budgeting and organizational charts consistent with its functional statements.

Our Response:

We have no quarrel with the thrust of this common-sense recommendation. We do wish to question some of the statements in your report leading up to the recommendation.

First, you refer on page 15 to previous “poorly planned reorganizations.” This statement is not true and is made without foundation. Without commenting on previous reorganizations, we wish to assure you that the recent reorganization was not poorly planned. In fact, two years of careful analysis went into it, leading to an organizational structure that we believe best serves our mission.

Second, on page 16 you report that our directors had “varying ideas among them about the budget process.” By your account, though, all *hale* directors were recently appointed at the time of your field work, from three to six months earlier. OHA budgeting, like State budgeting, is done only once every two years. It is a complicated process involving the Legislature and “A,” “B,” and “C” categories. These directors had not yet been through a biennium budgeting cycle and were working with a budget that had been created by their predecessors a year earlier.

Since the time of your fieldwork, all of the *hale* directors have now been through a biennium budget cycle and are very knowledgeable about the OHA budget process. Therefore, this concern is now moot.

Third, on page 16 you claim inconsistencies in our organizational chart and functional statements. However, according to page 9 of your report, you conducted your audit from November 2003 through May 2004 and reviewed organizational charts and functional statements dated December 2003, well over a year ago. It is now well into 2005. If any perceived inconsistencies existed at that time, we have since resolved them in the process of strengthening our organizational structure and fine-tuning our organizational chart in support of our mission and current priorities. At your staff’s request, we even provided you with an updated organizational chart as of December 2004. To issue an audit report in 2005 charging that inconsistencies existed in 2003 seems to be an unproductive exercise.

Recommendation #2.b:

The Office of Hawaiian Affairs should revise its Administrative and Financial Manual of Guides to clarify the purpose of expenditures made from petty cash, protocol allocations, and trustee allowances, to require appropriate support for all such expenditures, and to convert payment of trustee expenses to a reimbursement arrangement.

Our Response:

We share your belief in the importance of organizations establishing management controls on expenditures. Indeed, we are in the process of bolstering our management controls through a hierarchy of executive and operational policies and procedures flowing down from the Board of Trustees through Administration that will, among other things, make it ever more clear what expenditures are allowed, what’s not allowed, and what sanctions exist for abuse. Approximately half of our new board policy manual will be devoted to the elements of fiduciary duty.

Again, however, we take issue with your argument. You note on page 17 “possible abuse of protocol funds, petty cash, and trustee expense accounts.” From this speculative statement, you make a major leap of logic to the conclusion that our administration of our finances is “casual” and does not demonstrate our respect for our fiduciary duty to Hawaiians.

Furthermore, we dispute the significance you attach to relatively minor expenditures for such activities as farewell luncheons, a staff awards ceremony, and a microwave oven for staff. Such expenditures express recognition of deserving individuals and a commitment to boosting staff morale, both of which can indirectly benefit our beneficiaries. Morale-boosters are particularly useful for OHA staff, whose salaries lag behind other sectors and who serve as at-will employees without civil service and collective bargaining protections.

You question a farewell party for “an independent contractor who continues to provide services to the office.” However, your description shows insensitivity to the fact that the party honored an individual who was departing as the attorney for the Board of Trustees after many years of faithful service and unique contributions to OHA’s formation. Furthermore, you say you found “more than \$800 in petty cash payments made without a receipt or any other documentation to support the expenditure.” We do have documentation; it is puzzling that your staff did not ask for it. With regard to Trustee expenditures, we continue to make every effort to apply adequate controls. We wish to point out that one case, OHA administration made repeated requests to a Trustee for an accounting but received no response. Other than one particular Trustee, all other Trustees provided timely protocol fund reports in compliance with policy guidelines.

Recommendation #2.c:

The Office of Hawaiian Affairs should provide tighter oversight of loans made from the Native Hawaiian Revolving Loan Fund to prevent the financial deterioration of loan recipients, such oversight to include but not be limited to the provision of training and technical assistance to loan recipients, both pre-application and post-loan disbursement.

Our Response:

Your suggestion on page 20 of “deep-rooted problems” in our administration of the Native Hawaiian Revolving Loan Fund is unsupportable. Here’s why:

While you started by using the correct numbers from the fund’s monthly loan delinquency report, you did not compute the delinquency rate according to the standard prescribed by the federal Agency for Native Americans (ANA), which is the fund’s federal program manager. As a result, you report a delinquency rate of about 73 percent when the actual rate is about 15 percent. You used a formula that takes all delinquent loans (loans over 30 days past due), adds all non-performing loans (loans that are to be “charged off”) and then divides the total by total outstanding loans. This calculation becomes $\$500,233 + \$1,928,901$ divided by $\$3,330,353$, resulting in a delinquency rate of 72.9 percent. However, in the industry and ANA, no one includes “charge offs” or defaults in the calculation. ANA’s recommended formula is

accounts past due (loans over 30 days past due) divided by total outstanding loans, or \$500,233 divided by \$3,330,353, for a delinquency rate of 14.69 percent.

Furthermore, you charge us with “inadequate collection efforts” without stating your measure of “inadequate.” We note that loan payments and delinquencies are monitored monthly by the assigned loan officer and by a loan collection specialist. Subsequent to your 2001 audit, the percentage of loans in default has decreased substantially. From the fund’s inception, the overall default rate is 24.8 percent (\$3,963,311 divided by \$15,964,536). However, in the four years since your 2001 audit, the default rate is only 2.5 percent (and represents only one defaulted loan \$42,532 out of \$1,682,625 in loans made in that period).

Moreover, you say it is incumbent on OHA to mitigate risk by closely monitoring the status of loans and providing guidance to clients through specialized training and technical assistance. In fact, OHA contracts with outside providers to assist loan applicants and recipients in bookkeeping and the preparation of financial statements and has done so on a regular basis for many years. At present, we have nine accounting firms providing these services: two on Oahu, two on Hawai‘i, four on Maui, and one on Kauai.

In addition, you claim there is no systematic tracking of post-loan disbursement training and technical assistance to ensure clients are receiving services needed. Yet in fact, a post-loan monitoring program has existed since 2002 with SCORE and the Native Hawaiian Chamber of Commerce, which specifically provides post-loan assistance to recipients as needed. The tracking of the success or failure of this counseling is documented in the fund’s records. At present, both above organizations and eight other contracted service providers, provide post-loan training and technical assistance annually.

Finally, you claim OHA has not studied the attributes of successes and failures to better predict loan outcomes and to identify those areas in which loan recipients could benefit from training and other assistance. Nothing could be further from the truth. In fact, the fund has been studied as to its successes and failures on three different occasions within the last three years (by the UH Mānoa College of Business, by SMS Research, and by ANA), with subsequent recommendations being made to the fund’s advisory board and the OHA Board of Trustees.

We wish to conclude our response to your Chapter 2 recommendations with some heartfelt observations. Since your previous audit, OHA has successfully implemented one of the most ambitious educational and advocacy agendas in its history, always in the interests of our native Hawaiian and Hawaiian beneficiaries but benefiting the larger public as well. In the area of nation-building alone, we have sponsored a significant number of public, political, and media forums and discussions, giving all sides of the nationhood debate free rein to express their views and providing an opportunity for political candidates to state their positions on Hawaiian issues. We have brought to Hawai‘i national and international experts to share their expertise and views on native issues. We have collaborated and cooperated with an extensive list of external organizations to improve the conditions of native Hawaiians and Hawaiians, truly acting as a coordinator and facilitator as envisioned by Chapter 10, HRS. We work and coordinate with virtually every existing Hawaiian organization and all applicable non-Hawaiian organizations. We have instituted a State of OHA address that brings our constituents together, describes what

we have done and plan to do, and reaches all segments of the state's population. We have made significant internal improvements including a strategic plan developed with extensive outside input.

We believe that your audit could have done much more to capture the heart and soul of what we do, how we have done it, and what we plan to do. We are always ready to assist you in raising your reports to this higher level.

FROM CHAPTER 3 OF YOUR REPORT

The title of Chapter 3 of your report does not accurately represent the contents of the chapter. The title claims that deficiencies in OHA's investment management oversight do not ensure compliance with our fiduciary obligations. However, the text of the chapter, apparently prepared by your consultant, does not provide evidence that our fiduciary duty has not been ensured. However, the contrary is true. The title also fails to inform your readers, including our beneficiaries, of the very fact that they would probably be most interested in: that our investments have been generating impressive financial gains for the trust. One must burrow deep into the chapter to find mention of our recent excellent investment returns, which your consultant reports on page 32 as a return of 24.3 percent during 2003, "which was better than 86 percent of other public investment funds." Therefore, we are very puzzled by your chapter heading statement. The Trustees, in 2003, have totally restructured its investment policy guidelines and asset management and have instituted stricter oversight guidelines and management contracts which achieved unprecedented investment returns than ever before.

Recommendation #a.i.:

Delineate the legislative and procedural authority of OHA and the Board of Trustees to make and refine investment policy.

Our Response:

Section 10-5, HRS describes the legislative authority of OHA to make and refine investment policy. Portions of the applicable statute are set forth below:

§10-5 Board of trustees; powers and duties. The board shall have the power in accordance with law to:

- (1) Manage, invest, and administer the proceeds from the sale or other disposition of lands, natural resources, minerals, and income derived from whatever sources for native Hawaiians and Hawaiians, including all income and proceeds from that pro rata portion of the trust referred to in section 10-3;
- (2) Exercise control over real and personal property set aside to the office by the State of Hawaii, the United States of America, or any private sources, and transferred to the office for native Hawaiians and Hawaiians;

(3) Collect, receive, deposit, withdraw, and invest money and property on behalf of the office;

(4) Formulate policy relating to the affairs of native Hawaiians and Hawaiians, provided that such policy shall not diminish or limit the benefits of native Hawaiians under article XII, section 4, of the state Constitution;

(5) Otherwise act as a trustee as provided by law;

...

With respect to procedural authority, we believe that such authority is inherent in the statutes and duties of the Board. In this regard, the Board is currently developing a Board of Trustees Executive Policy Manual which addresses governance and decision making by the Board as well as management of financial and other trust assets, fiduciary responsibilities, and acquisition of trust assets including real property. At present, the Board has two major policies regarding financial management: The OHA Investment Policy and the OHA Spending Policy.

A companion Board Operations Manual will contain specific procedures for implementing and operationalizing the Board's policy.

Recommendations #a.ii. through #a.v., Recommendations #b. and Recommendation #c:

Our Response:

We appreciate your consultant's recommendations in Chapter 3. We will not take the time to comment to each, however, we will deal with each as we proceed with implementation. In the overall, we appreciate that these recommendations will improve and add to the Trustees' skills towards the management of the funds that we manage for the benefit of our Hawaiian people. These recommendations raise the bar for oversight of the trust funds that we manage. While a number of these recommendations will greatly assist the Trustees in this effort, alignment of the management contracts to standardize contract provisions for both organizations will be a challenge. Not (OHA) having a "standard contract form" or any contract at all to work from, and because both firms had their own contract form, it was a grueling process to develop a standard contract acceptable to both Frank Russell and Goldman Sachs.

We will immediately begin the process of analyzing and weighing your recommendations concerning our investment policies and practices. The executive policies that we are currently crafting will provide the practical means for addressing those of your investment recommendations with which we may agree.

Central to our implementation of your recommendations, are the Board of Trustees Executive Policy Manual and companion Board Operations Manual discussed above.

We hope that neither you nor our readers will interpret this short response to your

Chapter 3 as a negative reflection on the importance of that chapter. Maintaining and growing the value of the trust assets is a priority concern of the Board of Trustees. This brief response simply is intended to thank you for your insights and pledge our commitment to the additional time and effort needed for assessing the recommendations, and if prudent, implementing them.

Sincerely,

A handwritten signature in black ink, reading "Haunani Apoliona". The signature is fluid and cursive, with the first name being larger and more prominent than the last name.

Haunani Apoliona
Chairperson
Board of Trustees

Submitted in behalf of the Board of Trustees:

Trustee John Waihe'e IV, Vice Chairperson
Trustee Dante Carpenter, Chairman of the Committee on Asset and Resource Management
Trustee Colette Machado, Chairperson of the Committee on Beneficiary Advocacy
Trustee Rowena Akana
Trustee Donald Cataluna
Trustee Linda Dela Cruz
Trustee Boyd Mossman
Trustee Oswald Stender

Enclosure/1 (Draft March, 2005 OHA Master Plan)